

April 29, 2010

Large Trader Reporting System

SEC Proposes Creation of a Reporting and Information-Gathering System Applicable to Certain Large Market Participants and U.S. Registered Broker-Dealers

SUMMARY

The SEC has proposed a new Rule 13h-1 and a corresponding Form 13H to establish a new large trader reporting system. The system would require large traders to self-identify and file reports with the SEC and would require registered broker-dealers that service them to comply with related recordkeeping and reporting requirements. Specifically, a “large trader” would be defined as any person, whether an entity or a natural person, that, in the exercise of investment discretion with respect to NMS securities, has a trading volume in such securities that equals or exceeds (i) two million shares or \$20 million during any calendar day or (ii) 20 million shares or \$200 million during any calendar month. A large trader would be required to file a Form 13H, containing information about the nature of the trader’s business, affiliates and operations, with the SEC promptly after crossing the relevant trading threshold and to update the form at least annually and, in the event of any change in the information on file, on a quarterly basis. Large traders that have filed a Form 13H but have not engaged in the threshold level of activity at any time during a full calendar year would be permitted to file a Form 13H declaring their inactive status and would not thereafter be required to file a form unless they once again crossed the trading threshold.

Upon filing its first Form 13H, a large trader would receive a large trader identification number (“LTID”). The large trader would be required to provide its LTID to each registered broker-dealer at which it maintains an account and advise the broker-dealers of each account to which the LTID applies. The large trader would also be required to provide its LTID to any other party with whom the large trader collectively exercises investment discretion, thereby allowing other large traders to comply with their obligation to disclose the LTIDs of all other large traders who exercise such discretion over the accounts listed on the Form 13H. Broker-dealers would be required to maintain records of information required by the rule with respect to all transactions effected directly or indirectly by or through (i) an account the

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broker-dealer carries for a large trader, (ii) an account over which the broker-dealer exercises investment discretion together with the large trader and (iii) if the broker-dealer is itself a large trader, any proprietary account over which it exercises investment discretion. Broker-dealers would also be required (i) to establish and maintain systems and procedures to assure compliance by large traders with the identification requirements of the rule and (ii) to provide information to the SEC at its request on transactions effected by or for large traders, with a requirement that the information be available by the morning of the next day after the reportable transactions are effected (including Saturdays and holidays).

The SEC is seeking comment on proposed Rule 13h-1 and Form 13H. The SEC has also asked for comments on a number of specific questions related to the implementation of the new large trader reporting system. Comments are due by June 22, 2010.

BACKGROUND

In response to the market volatility of the late 1980s, Congress passed the Market Reform Act of 1990 (the "Market Reform Act"), which granted the SEC the authority to establish a large trader reporting system and to prescribe appropriate rules and regulations. According to the SEC, the primary goal of the Market Reform Act was to provide the SEC with authority to collect broad-based information on large traders, including trading activity and timing, in order to evaluate market volatility and to enhance the SEC's ability to detect illegal trading activity. The SEC proposed rules in 1991 and 1994 to implement a large trader reporting system, but ultimately did not adopt those rules. Instead, the SEC adopted Rule 17a-25 to enhance the Electronic Blue Sheet ("EBS") system¹ by requiring certain information from registered broker-dealers with respect to their trading and operational activities. Following the most recent market turmoil, the SEC found that the current EBS system was subject to lengthy delays, was insufficient for large-scale reporting and failed to require information with respect to the time of execution and the identity of the trader.

In order to correct these perceived drawbacks, the SEC issued its current proposal, which was published in the Federal Register on April 23, 2010.² The SEC believes that its proposal, which would create a large trader reporting system using the existing infrastructure of the EBS system, "would enhance its ability to identify large market participants, collect information on their trades, and analyze their trading activity".

¹ EBS is a system established by the SEC in 1988, pursuant to which staff may request certain securities transaction data from registered broker-dealers for purposes of assisting in the investigation of possible federal securities law violations and reconstructing market activity.

² Release No. 34-61908 (April 14, 2010) (the "Proposing Release").

PROPOSAL

The new rule would define “large trader” to mean “any person that 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 security³ 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” (i) two million shares or \$20 million during any calendar day or (ii) 20 million shares or \$200 million during any calendar month.⁴

The definition of large trader is intended to capture nearly all transactions in publicly traded securities (including not only purchases and sales of listed options but also exercises or assignments of option contracts), with limited exceptions for transactions that are not typically characterized by the exercise of investment discretion, including: (i) journal or bookkeeping entries made to record the receipt or delivery of funds or securities pursuant to the settlement of a transaction, (ii) transactions that are part of an offering by or on behalf of an issuer, by an underwriter on behalf of an issuer or by an agent for an issuer, (iii) gifts, (iv) transactions effected by a court-appointed executor, administrator, or fiduciary pursuant to the distribution of a decedent’s estate, (v) transactions effected pursuant to a court order or judgment, (vi) transactions made pursuant to a rollover of qualified plan or trust assets subject to Section 402(c)(1) of the Internal Revenue Code and (vii) transactions between an employer and its employees effected pursuant to the award, allocation, sale, grant or exercise of securities, options or other rights to acquire securities at a pre-established price pursuant to certain benefit plans or compensatory arrangements. Persons without “investment discretion”,⁵ such as nominees, custodians or certain trustees, would not be considered large traders for purposes of the rule.

A. LARGE TRADER SELF-IDENTIFICATION

General Requirements. Persons who qualify as a large trader would be required, pursuant to Rule 13h-1(b)(1), to file a Form 13H with the SEC promptly⁶ following the first transaction that, together with all

³ “NMS security” is defined in Rule 600(b)(46) of Regulation NMS and refers in general to any exchange-listed security, including equities and options.

⁴ Such amounts represent a number that is approximately 0.01% of the SEC’s estimate of the average daily and monthly trading volumes in NMS securities and the corresponding market value of such trading multiplied by two in order to reflect both buy and sell sides of each transaction.

⁵ “Investment discretion” has the same meaning as in Section 3(a)(35) of the Exchange Act. A person has investment discretion over an account if the person: (i) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (ii) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for such investment decisions or (iii) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the SEC may determine under its rulemaking authority.

⁶ As discussed below, the SEC has requested comment on a possible definition of the term “promptly”.

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other transactions made by such person during the applicable calendar day or month, exceeds the relevant threshold. The SEC designed Form 13H to capture basic information on each large trader consistent with the purpose of the new rule, including:

- the type of business engaged in by the large trader;
- whether the large trader or any of its affiliates files forms with the SEC (such as Form BD, Form ADV or Form 10-K) and, if so, the applicable SEC File numbers and CRD numbers;
- whether the large trader or any of its affiliates is: (1) a registered trader or otherwise registered with the Commodity Futures Trading Commission, (2) a bank holding company, national bank, state member bank of the Federal Reserve System, state non-member bank, savings bank or association, credit union or foreign bank, (3) an insurance company or (4) regulated by a foreign regulator, as well as certain follow-up information responsive to each category;
- basic business information concerning the large trader, such as its jurisdiction of organization, whether it exercises investment discretion as a trustee, partnership or corporation, certain information on its management and, in the case of a natural person, whether the person is self-employed or otherwise employed;
- information about any affiliates of the large trader that either exercise investment discretion over accounts holding NMS securities or that beneficially own NMS securities; and
- information concerning all other accounts over which the large trader exercises investment discretion.

Large traders would thereafter be required to file an updated Form 13H within 45 days after the end of each calendar year in all cases, and promptly following the end of each calendar quarter but only to the extent that any of the information contained in the Form 13H has become inaccurate for any reason. A large trader that has not met the relevant quantitative thresholds for at least one calendar year may file a Form 13H declaring its status as inactive, and will no longer be obligated to comply with Rule 13h-1 until it again crosses the trading threshold. If a large trader ceases trading operations, it may file an amended Form 13H to indicate its terminated status. Under the rule, the SEC would also have the power, at its sole discretion, to require large traders to provide it with additional information that would allow the SEC “to further identify the large trader and all accounts through which the large trader effects transactions”.

Identity of the Filing Party. Proposed Rule 13h-1(b) is designed such that if an ultimate parent company satisfies its obligations under the rule, none of the entities it controls⁷ would be required to comply with the rule, and no natural persons employed by an entity within the holding company structure would be required to file, to the extent that such persons exercise investment discretion and conduct

⁷ For purposes of Rule 13h-1, “control”, “controlling”, “controlled by” and “under common control with” each means 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. Any person that directly or indirectly has the right to vote or direct the vote, or the power to sell or direct the sale, of 25% or more of a class of voting securities of an entity (or in the case of a partnership, persons who have contributed, or who have the right to receive upon dissolution, 25% or more of the capital) will be presumed to control that entity.

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trading solely in their official capacities. However, if controlling persons do not satisfy their obligations under the rule, each controlled person that exercises investment discretion over any applicable accounts must separately comply. In constructing the rule in this manner, the SEC noted its belief that the focus on parent companies will “reduce the burden of the proposed rule by requiring self-identification by a concentrated group of parent companies, while capturing those organizations that in the aggregate are responsible for exercising investment discretion over the trading of a substantial volume or fair market value of NMS securities”.

Foreign Entities. The proposal applies to any entity, regardless of nationality. A non-U.S. person could be subject to the large trader identification procedures if such person satisfies the definition of large trader under proposed Rule 13h-1 and, pursuant to the statutory authority underlying the rule, effects the relevant transactions through the use of any means or instrumentality of interstate commerce or the mails or any facility of a national securities exchange.⁸ The SEC notes that non-U.S. broker-dealers that are not U.S.-registered would not be subject to the broker-dealer recordkeeping or transaction reporting requirements of the proposed rule. In the Proposing Release, the SEC provides the example of a non-U.S. investment adviser that maintains accounts with a U.S.-registered broker-dealer and effects trades of NMS securities on a national securities exchange for clients who are citizens of, or persons domiciled in, a foreign country. That adviser would be required to file a Form 13H, which must include all available LTIDs of clients that are also subject to the rule, and to disclose the adviser’s LTID to its registered broker-dealer and anyone else with whom it shares investment discretion.

Disaggregation. Rule 13h-1(c)(2) expressly prohibits persons from disaggregating accounts to avoid identification and the other requirements imposed on a large trader. Potential large traders would be prohibited from splitting activity among multiple registered broker-dealers, accounts or transactions for the purpose of evading the large trader identification requirement. Moreover, the SEC has indicated that “where two separate entities engage in a coordinated trading strategy that results in the joint exercise of investment discretion over their individual accounts, each entity must count the transactions in NMS securities effected through those ‘joint’ accounts toward its identifying activity level”.⁹

B. BROKER-DEALER RECORDKEEPING AND REPORTING

General Requirements. While the Proposing Release emphasizes the SEC’s stated intent to put the self-identification requirement directly on the large traders themselves, Rule 13h-1 would impose recordkeeping and reporting obligations on registered broker-dealers. When a larger trader submits its initial Form 13H, it will receive an LTID from the SEC. The large trader would then be required to disclose

⁸ See 15 U.S.C. §78(h)(8)(A).

⁹ Apparently, the SEC is using the term “separate entities” in this context to refer to unaffiliated large traders.

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its LTID to all registered broker-dealers effecting transactions on its behalf and each account to which it applies, as well as to all others with whom it collectively exercises investment discretion.

Under the proposed rule, registered broker-dealers would be required to maintain records of certain information for all transactions they effected directly or indirectly by or through: (i) an account carried by a large trader, (ii) an account over which the broker-dealer exercises investment discretion together with a large trader and (iii) if the broker-dealer itself is a large trader, any proprietary or other account over which the broker-dealer exercises investment discretion. If a non-broker-dealer carries an account for a larger trader, the broker-dealer effecting transactions directly or indirectly for such large trader would be required to maintain the appropriate records.

Responsibility to Monitor Unidentified Large Traders. The recordkeeping requirements applicable to registered broker-dealers would also extend to “Unidentified Large Traders”, a term defined under Rule 13h-1 to mean each person who has not complied with the large trader identification requirement “that a registered broker-dealer knows or has reason to know is a large trader”. While the SEC acknowledges that such a duty to monitor its customers would impose a burden on registered broker-dealers, it nonetheless believes that requiring some form of monitoring by the entities that are in the best position to know the details of a large trader’s account would help assure that the objectives of the rule are met.

In order to minimize the burden on registered broker-dealers, the rule contains a safe harbor from the duty to monitor for Unidentified Large Traders, under which a registered broker-dealer will not be deemed to know or to have reason to know that a person is an Unidentified Large Trader if: (i) it does not have actual knowledge that a person is a large trader and (ii) it has established and maintained policies and procedures reasonably designed to assure compliance with the identification requirements of the proposed rule. Policies and procedures would be within the safe harbor if they include systems reasonably designed to detect and identify Unidentified Large Traders based upon transactions effected through an account or a group of accounts considering account name, tax identification number or other information readily available to the broker-dealer, and systems reasonably designed to inform Unidentified Large Traders of their obligations to file Form 13H and disclose large trader status to the SEC.

Specific Recordkeeping and Reporting Requirements. The list of information registered broker-dealers would be required to maintain under Rule 13h-1 with respect to transactions by large traders and Unidentified Large Traders is similar to what registered broker-dealers are currently required to provide under Rule 17a-25 and the existing EBS system, except that the new rule would also require the broker-dealer to record: (i) the applicable LTID and (ii) the transaction execution time.¹⁰ For Unidentified Large

¹⁰ The information required to be maintained by registered broker-dealers includes, for each relevant transaction: (1) the date the transaction was executed, (2) the account number, (3) the identifying symbol assigned to the security, (4) the transaction price, (5) the number of shares or option
(Footnote continued)

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Traders, the broker-dealer would also be required to record the person's name, address and tax identification number and the date the account was opened.

Under the reporting requirements of the new rule, registered broker-dealers may be required, at the SEC's discretion, to transmit the requested information to the SEC in electronic format. This reporting obligation would apply to all transactions that are equal to or greater than a specified reporting activity level, which would be determined as follows: (i) each transaction in NMS securities, effected in a single account during a calendar day, that is equal to or greater than 100 shares, (ii) any other transaction in NMS securities, effected in a single account during a calendar day, that a registered broker-dealer may deem appropriate or (iii) such other amount that may be established by order of the SEC from time to time. In the Proposing Release, the SEC noted that it established a deliberately low reporting activity level with the intent that it would result in the reporting of substantially all large trader activity in response to a request for data, and take into account situations where large traders have broken-up large orders across multiple market centers in order to maintain confidentiality and to minimize any market impact. The SEC believes that this reporting requirement could be accomplished using a format based on the existing EBS system.

Pursuant to proposed Rule 13h-1, all of the information that registered broker-dealers are required to maintain must be available for disclosure to the SEC on the morning after the day that each reportable transaction is effected, including Saturdays and holidays. When a report of transaction information is requested by the SEC, the rule provides that such report must be in machine-readable form and in accordance with instructions issued by the SEC and that the report must be delivered before the close of business on the day specified in the SEC's request.

Confidentiality. The statutory authority for the proposed rule provides for an exemption under the Freedom of Information Act ("FOIA"). Consequently, the information that a large trader would be required to disclose on proposed Form 13H or to provide in response to an SEC request, as well as any

(Footnote continued)

contracts traded, (6) whether the transaction was a purchase, sale or short sale and, if an option contract, whether it was a call or put option, an opening purchase or sale, a closing purchase or sale or an exercise or assignment, (7) the clearing house number of the entity maintaining the transaction information and the clearing house numbers of the entities on the opposite side of the transaction, (8) a designation of whether the transaction was effected for the account of a customer of the registered broker-dealer, or was a proprietary transaction effected for the account of the broker-dealer, (9) the identity of the exchange or other market center where the transaction was executed, (10) the time that the transaction was executed, (11) the LTID(s) associated with the account, unless the account is for an Unidentified Large Trader, (12) the prime broker identifier, (13) the average price account identifier and (14) if the transaction was processed by a depository institution, the identifier assigned to the account by the depository institution.

transaction information that a registered broker-dealer would be required to report to the SEC, would be exempt from disclosure under the FOIA.¹¹

IMPLEMENTATION AND NEXT STEPS

In the Proposing Release, the SEC requests public comment on the proposed rule generally, while also identifying a number of specific issues for commentators to address, including whether:

- Definitions used in the proposed rule are sufficiently clear;
- The requirement that filings be made “promptly” should be replaced with a requirement that they be made within ten business days;
- The rule is appropriately focused on requiring identification of the large trader at the parent company level or whether large traders should be identified at lower levels;
- The annual filing requirement is redundant in light of the obligation to file updated Forms 13H quarterly when information has changed;
- The rule should exempt certain persons, for example, broker-dealers that do not carry accounts for themselves or others;
- It is reasonable to require broker-dealers to provide information the morning of the next day after a request is made, including Saturdays and holidays;
- A system that required daily or weekly reporting by broker-dealers, instead of reporting on request, would be unduly burdensome;
- The rule would cause some large traders to make changes in how and where they trade; and
- The requirement for reporting by foreign entities is appropriate.

The Proposing Release notes that the SEC staff is developing, for consideration by the SEC, a proposal to establish a consolidated audit trail for equities and options that would collect and consolidate detailed information about orders entered and trades executed on any exchange or in the over-the-counter market. The SEC believes that the large trader reporting system will continue to provide a uniquely valuable tool even after establishment of the consolidated audit trail because of its focus on the activities of large traders.

Comments are due on the proposed rule by June 22, 2010. The SEC expects that the proposed rule would become effective three months after the adoption of a final rule, except for the provisions requiring broker-dealer reporting and recordkeeping, which would become effective six months after adoption of a final rule.

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¹¹ See 5 U.S.C. §552(b)(3)(B).

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