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## SEC Adopts Rule Requiring Large Trader Reporting

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The "flash crash" of May 6, 2010 intensified the spotlight on the ability of the U.S. Securities and Exchange Commission ("Commission") to gather and analyze information on market events. At that time, a rule already had been proposed to enhance the Commission's capacity to collect information on the trading activity of significant participants in U.S. markets. On July 27, 2011, the Commission adopted, with certain modifications, proposed Rule 13h-1 under the Securities Exchange Act of 1934, the "large trader reporting" rule.<sup>1</sup> Rule 13h-1 will require "large traders" who exercise investment discretion and trade above specified volume thresholds to self-identify by (1) filing Form 13H with the Commission, and (2) providing a unique identification number, assigned by the Commission, to broker-dealers through whom they trade. Broker-dealers in turn will be required to maintain records of trading similar to the records they currently maintain in connection with the Electronic Blue Sheets ("EBS") system, supplemented with the time of order execution and the trader's ID number, and to report that information to the Commission on request. They also will be required to file Form 13H if they are large traders themselves.

Firms that trade NMS securities at or near the "large trader" thresholds discussed below, including investment advisers (whether registered or unregistered), banks, broker-dealers, and foreign entities, should consider whether they will be required, or may wish, to file Form 13H. Separately, registered broker-dealers that effect customer transactions or that will file Form 13H themselves should begin to prepare for compliance with the recordkeeping and reporting requirements of the Rule.

**Large Trader Status, Form 13H, and LTIDs.** Rule 13h-1(a)(1)(i) defines a "large trader" generally as any person who directly or indirectly (including through other controlled persons) exercises investment discretion over one or more accounts and effects transactions in NMS securities for such accounts, through one or more registered broker-dealers, in an aggregate amount equal to or greater than the "identifying activity level," defined as aggregate transactions in NMS securities<sup>2</sup> that are equal to or greater than:

- 2 million shares or \$20 million in a calendar day; or
- 20 million shares or \$200 million in a calendar month.<sup>3</sup>

A large trader must self-identify by filing Form 13H with the Commission through EDGAR, providing certain information about its operations (including a general description of trading strategies), whereupon the Commission will issue a large trader ID number ("LTID"). A person or entity also may become a large trader by voluntarily registering as such, without regard to the trading thresholds above—for example, to obviate the need to monitor its trading activity on an ongoing basis.<sup>4</sup> A large trader must disclose its LTID to each broker-dealer that effects transactions on its behalf.

**Investment Discretion.** In the case of investment companies (both registered and unregistered), the adopting release notes that the investment adviser and not the investment company exercises investment discretion,<sup>5</sup> and thus may fall within the definition of "large trader." Pension fund managers therefore may be large traders.<sup>6</sup>

**Parent Company Level Registration.** The Rule defines a "large trader" (in part) as a person that exercises investment discretion "directly or indirectly, including through other persons controlled by such person." This definition focuses on the ultimate parent company of entities under common control.<sup>7</sup> "Control" is defined generally as the direct or indirect power to direct or cause the direction of the management and policies of a person, with a presumption of control at 25% ownership.<sup>8</sup> To determine whether a parent company is a large trader, the aggregate trading activity of all controlled entities must be collected. The aggregated statistics must be added together at the parent level to determine whether the relevant thresholds are met; if so, the parent must report under the rule unless all of its affiliates comply on its behalf.<sup>9</sup> The adopting release notes that this requirement to aggregate trading across affiliates should not threaten the integrity of inter-affiliate firewalls, as the information required by Form 13H relates only to aggregated transactions and not to specific individual transactions.<sup>10</sup> (Information relating to particular transactions will instead be retained, and reported to the Commission on request, by executing broker-dealers, as discussed below.) In addition, the rule permits (but does not require) a large trader to assign suffixes to its LTID to identify persons, divisions or entities under the large trader's control, which may allow large traders to more easily respond to Commission inquiries regarding trading data.<sup>11</sup> Firms subject to the Rule's requirements will need to consider whether they wish to assign such suffixes to separate trading units, funds, or other entities under their control.

Conversely, affiliates under common control of an ultimate parent company may comply separately with the Rule (and the parent then need not comply). Each affiliate would identify the other affiliate(s) and the ultimate parent on Form 13H; as a result, the Commission may identify the entities as being under common control and may assign LTIDs that reference the common parent.<sup>12</sup>

**Counting Transactions.** To determine whether trading activity meets the "identifying activity level," offsetting transactions must be "grossed up," including for hedged positions.<sup>13</sup> Purchases and sales of options must be counted, but not transactions in underlying securities pursuant to options exercises or assignments.<sup>14</sup> Certain transactions are excluded for purposes of the identifying activity level (but not for broker-dealer recordkeeping and reporting purposes); these include OTC offerings by issuers and underwriters (registered and unregistered), merger and acquisition transactions,

tender offers, issuer stock buybacks, and stock loan and equity repurchase transactions.<sup>15</sup>

**Timing of Filings.** A large trader must file an initial Form 13H "promptly" after crossing the trading thresholds identified above; the Commission notes in the adopting release that "under normal circumstances," it would expect these filings to be made within 10 days.<sup>16</sup> Large traders also must submit an annual filing within 45 days after the end of each calendar year, and an amended filing by the end of a calendar quarter if any information in a previous filing becomes inaccurate. If a large trader self-identifies by filing Form 13H, but subsequently passes a full calendar year without meeting the identifying activity level, it may file for "Inactive Status," after which it will retain its LTID but will not be required to file until it meets the level again. At that point it must file "promptly" for "Reactivated Status"—again, typically within 10 days. Full termination of large trader status is permitted under limited circumstances (e.g., cessation of business operations).<sup>17</sup>

**Self-Identification to Broker-Dealers.** Rule 13h-1(b)(2) requires large traders to disclose their LTID, and each account to which it applies, to broker-dealers effecting transactions on their behalf. The Commission did not adopt a proposed requirement to disclose brokerage account numbers on Form 13H, though the form requires a list of registered broker-dealers with which the large trader has an account.

**Broker-Dealer Recordkeeping and Reporting.** Registered broker-dealers have responsibilities under the rule if:

- they are themselves large traders (in which case they must file Form 13H as described above and maintain records of all transactions in proprietary accounts and other accounts over which they exercise investment discretion);
- they carry an account, and effect transactions in that account, for a large trader or a person or entity that the broker-dealer knows or has reason to know has met the trading thresholds for a large trader but has not self-identified (an "Unidentified Large Trader"); or
- they effect transactions in an account carried by a non-broker-dealer (for example, by a bank) for a large trader or Unidentified Large Trader.

Such broker-dealers must maintain records of transactions in NMS securities<sup>18</sup> that generally track the information currently required of broker-dealers through the EBS system, with the addition of two data elements: time of order execution, and LTID (or, for Unidentified Large Traders, certain other identifying information).<sup>19</sup> Required records must be available on the morning of T+1, including on Saturdays and holidays.<sup>20</sup> Upon request from the Commission, broker-dealers must electronically report transaction information using the existing infrastructure of the EBS system. Broker-dealers may need to enhance their existing EBS infrastructure in order to comply with the new rule, including the provisions regarding overnight availability of data.<sup>21</sup>

**Broker-Dealer Monitoring Requirements.** As a result of the requirement to make records regarding transactions by Unidentified Large Traders, registered broker-dealers will need to monitor customer activity to flag traders that the broker-dealer has "reason to know" are large traders. For this

purpose, broker-dealers need only look to information available on their own books and records; a broker-dealer need not seek out information on transactions effected through other broker-dealers, nor is a clearing broker required to obtain information from an introducing broker to supplement its own information about a customer's trading activity.<sup>22</sup> A broker-dealer may conclude through its knowledge of a customer and the customer's trading activity that the customer's trading does not meet the relevant thresholds to be a large trader. Alternately, Rule 13h-1(f) provides a safe harbor for broker-dealers that establish policies and procedures reasonably designed to identify customers whose transactions equal or exceed the given thresholds, and to treat such persons as Unidentified Large Traders and notify them of their potential obligations under the Rule. The Rule does not require broker-dealers to stop doing business with Unidentified Large Traders.

**Foreign Entities as Large Traders.** The adopting release also discusses the application of Rule 13h-1 to foreign entities, noting that while the Rule permits foreign entities to be deemed large traders, such entities are only subject to the self-identification requirement (*i.e.*, the requirement to file Form 13H) and not to the recordkeeping and reporting provisions (which apply only to U.S. registered broker-dealers).<sup>23</sup> In addition, to the extent that a registered broker-dealer deals directly with a foreign intermediary that is a large trader (or an Unidentified Large Trader) and not with that intermediary's customers, the broker-dealer's obligations under the Rule relate only to its contact with the foreign intermediary; the broker-dealer is not required to seek identifying information about the underlying customers.<sup>24</sup> Although not discussed in the release, the same should be the case with respect to domestic intermediaries whose underlying customers a broker-dealer does not know.

**Implementation and Compliance Dates.** Large traders will be required to comply with the requirement to file Form 13H 120 days after the date the rule is published in the Federal Register. Registered broker-dealers will be required to implement the recordkeeping and reporting requirements of the Rule within 270 days (approximately nine months) after such publication.

**Confidentiality.** In the adopting release, the Commission states that it is committed to maintaining the confidentiality of information collected pursuant to the Rule, though it may be required to disclose information to Congress, other federal agencies, or pursuant to a federal court order.<sup>25</sup>

**Relation to Consolidated Audit Trail Proposal.** The Commission also has proposed to establish a consolidated audit trail for equities and options that would capture considerable customer and order event information for most orders in NMS securities.<sup>26</sup> As noted in the release, however, the consolidated audit trail would require the development of significant technological systems over a longer time frame, while firms should be able to implement the large trader reporting requirements relatively expeditiously and inexpensively. The Commission states that in considering the scope and requirements of a consolidated audit trail, it will take into account concerns about overlap or duplication with the large trader reporting rule.<sup>27</sup>

<sup>1</sup> See *Large Trader Reporting*, Exchange Act Release No. 64976, File No. S7-10-10 (July 27, 2011) ("Adopting Release").

<sup>2</sup> NMS security is defined in Regulation NMS, Rule 600(b)(46) 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." See Rule 13h-1(a)(5).

<sup>3</sup> Rule 13h-1(a)(7).

<sup>4</sup> Rule 13h-1(a)(1)(ii).

<sup>5</sup> "Investment discretion" is defined with reference to the definition in Section 3(a)(35) of the Exchange Act.

<sup>6</sup> Adopting Release at 19.

<sup>7</sup> Adopting Release at 19.

<sup>8</sup> Specifically, Rule 13h-1(a)(3) defines "control" (and the terms "controlling," "controlled by," and "under common control with") 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. For purposes of this rule only, any person that 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, is presumed to control that entity."

The presumption does not appear to be rebuttable.

<sup>9</sup> Adopting Release at 20-21.

<sup>10</sup> *Id.* at 21.

<sup>11</sup> *Id.* at 22.

<sup>12</sup> While not stated explicitly, presumably this is meant to suggest separate LTIDs that the Commission identifies in its records as each being linked to the parent.

<sup>13</sup> Adopting Release at fn.63.

<sup>14</sup> *Id.* at 27-28.

<sup>15</sup> Rule 13h-1(a)(6).

<sup>16</sup> Adopting Release at 38.

<sup>17</sup> Rule 13h-1(b)(3)(iii).

<sup>18</sup> While the language of the rule does not explicitly limit the recordkeeping requirement to transactions in NMS securities, the requirement to report information to the SEC upon request applies only to transactions that exceed the "reporting activity level," generally defined as transactions in NMS securities of 100 shares or more in a single account in a calendar day. Rule 13h-1(e). There is no suggestion in the release that the rule is intended to require broker-dealers to maintain records of transactions in non-NMS securities.

<sup>19</sup> Adopting Release at 14; Rule 13h-1(d)(2)-(3).

<sup>20</sup> Rule 13h-1(d)(5).

<sup>21</sup> Adopting Release at 66.

<sup>22</sup> Rule 13h-1(a)(9); Adopting Release at 98-99.

<sup>23</sup> If a foreign intermediary meets the definition of a large trader but the laws of its home jurisdiction preclude it from providing personal identifying information in a Form 13H filing, the intermediary may request from the Commission an exemption from filing Form 13H pursuant to Rule 13h-1(g). Rule 13h-1(g); Adopting Release at 80.

<sup>24</sup> Adopting Release at 77-80.

<sup>25</sup> *Id.* at 59-60.

<sup>26</sup> See p.14; Exchange Act Release No. 62174 (Mar 26, 2010), 75 Fed. Reg. 32556 (June 8, 2010) (File No. S7-11-10).

<sup>27</sup> Adopting Release at 15.

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