

April 20, 2010

SEC Proposes New Rule to Identify Large Traders, Including Insurance Companies

On April 14, 2010, the Securities and Exchange Commission (the "SEC") proposed a rule that would require persons that purchase or sell publicly traded securities in excess of certain amounts per month or per day to identify themselves to the SEC.¹ This rule would apply to insurance companies trading for their own accounts and any accounts over which they exercise investment discretion. The rule is designed to permit the SEC to monitor and analyze trading data on an almost contemporaneous basis and quickly investigate possible manipulations and other frauds. It would bring a new type of transparency to the U.S. securities markets because the trading of every person subject to the rule would be almost immediately "knowable" by the SEC.

Why the Rule was Proposed Now

If adopted, proposed new Rule 13h-1 would become part of the rules under the Securities Exchange Act of 1934 (the "Exchange Act").² It appears to be part of the SEC's response to recent changes in the U.S. markets for equity and option securities. Since becoming chairman of the SEC, Mary Schapiro has often voiced her concern that the SEC does not have ready access to information regarding persons that trade in large volume in the U.S. securities markets. The SEC release proposing new Rule 13h-1 states that it is designed to "facilitate the Commission's ability to assess the impact of large trader activity on the securities markets, to reconstruct trading activity following periods of unusual market volatility, and to analyze significant market events for regulatory purposes."³

Key Elements of the Rule

Who Would be Covered

The rule keys off the proposed definition of "large trader." As proposed, a large trader would be defined as a person that, in exercising investment discretion, effects transactions in exchange-listed equity securities or options, in an amount equal to or exceeding (i) during any calendar day, two million shares or shares with a fair market value of \$20 million, or (ii) during any calendar month, 20 million shares or shares with a fair market value of \$200 million.⁴

Specifically, the proposed rule defines a "large trader" as "any person that directly or indirectly, including through other persons controlled by such person, exercises investment discretion over one or more

¹ See SEC Release No. 34-61908; File No. S7-10-10 (April 14, 2010) (hereafter, the "Release").

² Section 13 of the Exchange Act ("Periodical and Other Reports"), paragraph (h) ("Large Trader Reporting"), authorizes the Commission to adopt rules requiring the identification of large traders and requiring such traders and the broker-dealers through which they trade to report to the Commission such information as the Commission may require. Heretofore, the Commission has not adopted any rules under Section 13(h), although it proposed rules under this section in 1991 and 1994.

³ Release at p.1.

⁴ These thresholds would measure gross transactions so that offsetting, netting and hedging positions in National Market System (NMS) securities would not be excluded from the count.

accounts and effects transactions for the purchase or sale of any [National Market System]⁵ security 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.”⁶ The word “person” would be defined expansively, as a natural person, company, government, or political subdivision, agency, or instrumentality of a government, and two or more persons acting as a partnership, limited partnership, syndicate, or other group, but not a foreign central bank.

The rule would capture within this definition:

- Brokers and Dealers
- Investment Advisers
- Insurance Companies
- Banks and other Financial Institutions
- Commodity Pool Operators
- Investment Companies registered under the Investment Company Act
- Pension Trustees
- Holding Companies
- Government Securities Brokers and Dealers
- Municipal Securities Brokers and Dealers
- Futures Commission Merchants and
- Hedge Funds and other Funds not registered under the Investment Company Act

If an entity identified above effects transactions in securities in the requisite volume or amount, and has investment discretion over the account(s) through which the transactions are executed, the entity would be required to identify itself to the SEC as a “large trader.”⁷

Importantly, the SEC has stated that it wants to know the identity of all large traders and the affiliates through which they trade. There is no exclusion in the proposed rule for certain types of entities that may need to trade frequently and in large volume (e.g., insurance companies or investment advisers). The proposal states that the definition of large trader:

is intended to focus, in more complex organizations, on the parent company of the entities that employ or otherwise control the individuals that exercise investment discretion. The purpose of this focus is to narrow the number of persons that would need to identify as “large traders” while allowing the Commission to identify the primary institutions that conduct a large trading business Accordingly, if a natural person or a subsidiary entity within a large organization independently qualifies as a large trader, but the parent company . . . identifies itself as

⁵ The Exchange Act defines a National Market System (NMS) security 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 SEC Rule 600(b)(46) of Regulation NMS.

⁶ Proposed Rule 13h-1(a)(1).

⁷ This list is not exhaustive; the proposed SEC registration form for large traders (new Form 13H) includes an “Other” category in addition to the named categories.

the large trader, then the natural person or subsidiary entity would not be required to separately identify itself as a large trader⁸

The SEC release recognizes that mere ownership of accounts – by trusts, custodians or nominees – through which a large amount or volume of securities transactions is effected, would not trigger large trader status for the owners of those accounts unless those owners either directly or indirectly exercise investment discretion. Trustees exercising investment discretion on behalf of trusts would be large traders.⁹

Requirement to Aggregate All Trading Within a Complex Organization

For purposes of determining how an organization would comply with the rule, large institutions organized in a holding company structure would be required to aggregate trading in accounts over which persons they control exercise investment discretion. For example, if a holding company had multiple subsidiaries or affiliates, some of which trade in the amount or volume specified by the rule, the holding company could comply with the rule by identifying itself to the SEC as the “large trader.” Alternatively, each subsidiary or affiliate that trades in the specified volume or amount could identify itself to the SEC as a “large trader.” However, large organizations would need to aggregate the trading of their subsidiaries and affiliates so that, even in a case where no single subsidiary or affiliate meets the trading threshold, the aggregate trading of the subsidiaries and affiliates is sufficient to meet the trading thresholds.

In this regard, the SEC stated that:

- It would generally expect a parent holding company to identify itself to the SEC as a large trader, on behalf of itself and each of its large trader subsidiaries;
- If a holding company has two subsidiaries that independently qualify as large traders, and only one subsidiary identifies itself as a large trader to the SEC, then the holding company still would be required to identify itself to the SEC as a large trader and include both of its subsidiaries in that filing; and
- If a firm employs two natural persons who exercise investment discretion and trade in an amount that would not individually qualify them as large traders, but, when taken together, the exercise of investment discretion and trading effected by those two natural persons would qualify the firm as a large trader, then the firm that employs the individuals must identify itself as a large trader to the SEC.

Note, however, that in the case of a registered investment adviser that acts as the adviser to several investment companies registered under the Investment Company Act, even if each fund is managed by a natural person that would meet the definition of large trader, the investment adviser, not the natural person who works for the investment company, would be required to identify itself as a large trader to the SEC because, in the SEC’s opinion, “the investment company would not directly or indirectly exercise investment discretion over one or more accounts.”

⁸ Release at pp. 16-17.

⁹ Release at p. 20 and footnote 49.

How the Rule Would Work

In proposing new Rule 13h-1, the SEC is also proposing the adoption of a new reporting form, Form 13H. Large traders would be required to submit new Form 13H to the SEC promptly after first effecting aggregate transactions equal to or greater than the trading level established by the SEC. Upon receipt of the form, the SEC would assign each large trader a “Large Trader Identification Number” or an “LTID.” Large traders would be required to update Form 13H annually and on a more frequent basis if information previously provided on the form has changed. A parent company that identifies itself as a large trader on behalf of affiliates that are large traders would be able to use a “sub-identification” system to append additional identifying characters to its LTID, so that the SEC and broker-dealers could identify the particular affiliate within the larger organization that is directly exercising investment discretion over a particular trading account (this ability to “sub-identify” affiliated entities would be voluntary, however).

The large trader would be required to disclose its LTID to each broker-dealer through which it trades, and identify all of the accounts through which it trades. Broker-dealers that accept trades from LTIDs would be required to maintain records that link each of a LTID’s trades to the LTID, and to capture, for each trade, the time of the transaction and other data related to each trade, such as the identity of the market where the transaction was executed.¹⁰ Broker-dealers would then be required to provide the SEC with any information the SEC requests with respect to the LTID – the information collected by broker-dealers would need to be available to the SEC on the day following the transaction date. Although the information would need to be readily available, broker-dealers would only be required to provide LTID information to the SEC in response to an SEC request for data.

The Importance of Investment Discretion

As noted above, the proposed large trader definition has two principal components: the amount and/or volume of transactions and the element of investment discretion. The definition only brings within its scope persons that trade in a certain volume and/or amount and exercise investment discretion over accounts that trade National Market System (NMS) securities. For purposes of the rule, the SEC has proposed to define “investment discretion” by reference to Section 3(a)(35) of the Exchange Act, which defines the term as follows:

A person exercises “investment discretion” with respect to an account if, directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold by or for the account [or] (B) 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

The proposed definition of “investment discretion” also states: “A person’s employees who exercise investment discretion within the scope of their employment are deemed to do so on behalf of such person.”¹¹

¹⁰ With the exception of transaction time and the identity of the LTID, proposed Rule 13h-1 would codify information that other SEC rules already require broker-dealers to capture.

¹¹ Proposed Rule 13h-1(a)(4).

Notably, the SEC makes clear that more than one entity can have investment discretion with respect to a single trading account.¹² It also makes clear that entities and persons that do not exercise investment discretion “either directly or indirectly through, for example controlled persons – would not be large traders, and so mere ownership of accounts – by trusts, custodians, or nominees, for example – through which the requisite number of securities transactions are effected would not trigger large trader status.”¹³ The SEC release states that for purposes of determining who should self-identify as a larger trader, investment discretion “would be considered to be indirectly exercised by a parent company by virtue of the direct or indirect power that the parent company exercises over its subsidiaries.”¹⁴

Exemptions

The SEC has proposed that certain types of transactions be exempt from the rule. These transactions are:

- Any journal or bookkeeping entry made to an account to record or memorialize the receipt or delivery of funds or securities pursuant to the settlement of a transaction
- Any transaction that is part of an offering of securities by or on behalf of an issuer, or by an underwriter on behalf of an issuer, or an agent for an issuer, whether or not such offering is subject to registration under the Securities Act of 1933, provided, however, that this exemption shall not include an offering of securities effected through the facilities of a national securities exchange
- Any transaction that constitutes a gift
- Any transaction effected by a court-appointed executor, administrator, or fiduciary pursuant to the distribution of a decedent’s estate
- Any transaction effected pursuant to a court order or judgment
- Any transaction effected pursuant to a rollover of qualified plan or trust assets subject to Section 402(a)(5) of the Internal Revenue Code, and
- Any transaction between an employer and its employees effected pursuant to the award, allocation, sale, grant or exercise of an NMS security, option or other right to acquire securities at a pre-established price pursuant to a plan which is primarily for the purpose of an issuer benefit plan or compensatory arrangement.

Affiliate Information

Proposed new Form 13H would require large traders to report certain information to the SEC regarding their affiliates, including the identity of each affiliate that either exercises investment discretion over accounts that hold NMS securities or that beneficially owns NMS securities. Additionally, the proposed rule would bring within its scope foreign entities (excluding foreign central banks) and persons that meet the definition of large trader (*i.e.*, foreign entities or persons that exercise investment discretion over accounts the aggregate transactions of which in NMS securities reach the threshold level and are executed through any means of interstate commerce).

¹² Release at p.52.

¹³ Release at p. 20.

¹⁴ *Id.*

Next Steps

The SEC has established a 60-day comment period on proposed Rule 13h-1, which will commence upon the publication of the proposed rule in the Federal Register. The SEC release proposing new Rule 13h-1 asks for comment on specific ideas, such as whether the LTID number should be structured so that it discloses both the identity of the parent company and the legal entity that effects the trade; whether the rule should be expanded to include over-the-counter derivatives trades; whether the SEC should require that more information be reported on affiliates; and whether the SEC should consider exempting certain categories of persons from the proposed rule.

We anticipate that many firms that are not principally engaged in the trading business, but nonetheless trade frequently in the course of their businesses, will need to analyze the potential impact of the proposed rule on their operations and affiliates. In this regard, companies may want to focus particularly on identifying which of their subsidiaries and affiliates could potentially be deemed to have investment discretion over securities transactions.



If you have any questions regarding this alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Stephen E. Roth	202.383.0158	steve.roth@sutherland.com
Holly H. Smith	202.383.0245	holly.smith@sutherland.com
David S. Goldstein	202.383.0606	david.goldstein@sutherland.com
Susan S. Krawczyk	202.383.0197	susan.krawczyk@sutherland.com