

## SEC Proposes Large Trader Reporting System

In an effort to enhance its ability to study and monitor U.S. securities markets, the Securities and Exchange Commission (SEC) proposed a new rule on April 14, 2010 to help identify persons that conduct substantial trading activity (large traders) and monitor their trading activity. The proposal would establish a new Rule 13h-1 (the Rule) and Form 13H under Section 13(h) of the Securities Exchange Act of 1934 (the Exchange Act). Rule 13h-1 generally would require any person to register with the SEC as a large trader by filing Form 13H if that person, together with persons it controls, has traded either two million shares or \$20 million of shares within a single day, or twenty million shares or \$200 million of shares within a calendar month. For purposes of determining whether an investment adviser exceeds these thresholds, trading activity in all accounts over which it exercises investment discretion would need to be aggregated. After filing Form 13H, a large trader would be assigned a unique Large Trader Identification Number (LTID), which that trader would then need to disclose to any registered broker-dealer through which it effects trades.

### Background

Section 13(h), which was added to the Exchange Act by the Market Reform Act of 1990, authorizes the SEC to establish a large trader reporting system to facilitate identifying large traders and monitoring their trading activity. The SEC previously proposed a rule under Section 13(h) in 1991, and repropoed it in 1994, to establish a large trader reporting system, but such a rule was never adopted. In the proposing release for the Rule, the SEC noted that the transition in recent years from manual trading to automated trading and other technological advances have led to trading by institutional investors at high speeds and in large volumes. The SEC suggested that a correlation exists between the speed and volume at which these large traders currently trade and recent increases in volatility in the stock markets, and noted the emergence of high frequency traders, who are estimated to account for more than 50% of total trading volume. Rule 13h-1 is intended to supplement the existing Electronic Blue Sheets system to provide the SEC with adequate information to monitor large traders and their trading activity.

### Identifying Activity Level

Rule 13h-1, as proposed, defines a large trader as a 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 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.” The identifying activity level proposed by the SEC includes aggregate transactions in NMS securities that are equal to or greater than: (1) during a calendar day, either two million shares or shares with a fair market value of \$20 million; or (2) during a calendar month, either twenty million shares or shares with a fair market value of \$200 million. The Rule would apply to NMS securities traded on a national securities exchange or through foreign or domestic over-the-counter markets and after-hours systems.

When determining whether a trader’s activity exceeds the identifying activity level, the Rule would require a trader to gross up offsetting or netting transactions within accounts, including hedged positions. The

Rule would treat transactions in options or on a group or index of securities as transactions in the underlying equity securities. The exercise of options would not be treated as a transaction under the Rule, only the purchase or sale of options. To determine the equivalent transaction volume for an options transaction on a single security, the number of options purchased or sold would be multiplied by the number of shares represented by each option. For index options, the market value of a transaction would be calculated by multiplying the number of option contracts purchased or sold by the index multiplier of the contracts, which would then be multiplied by the purchase or sale price. The calculated volume or market value of options transactions would need to be aggregated with the equity transactions for the relevant period.

The Rule would prohibit a trader from disaggregating accounts and trading activity, by effecting trades through multiple broker-dealers, accounts or transactions, for purposes of avoiding the large trader identification and reporting requirements. In addition, if two traders engaged in coordinated trading activity with the effect of exercising joint investment discretion over their individual accounts, they would each be required to include all transactions in these joint accounts in their respective activity level calculations.

The Rule would exempt from the definition of transaction certain types of transactions that the SEC does not believe warrant reporting. Exempted transactions would include, among others, transactions that are part of a plan by which an employer sells or grants shares of its stock to its employees, transactions that constitute a gift, transactions that are part of an offering of securities by an issuer or by an underwriter on behalf of an issuer (so long as they are not effected through a national securities exchange) and transactions that are effected pursuant to a court order or pursuant to the distribution of a decedent's estate.

### Form 13H

Under the Rule, a trader would be required to file Form 13H electronically with the SEC promptly after first effecting securities transactions in excess of the identifying activity level. Form 13H would require a large trader to disclose, among other things, whether it 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. Large traders meeting any of these four criteria would need to provide additional information regarding their regulated status. Form 13H would also require a large trader to provide basic business information about itself as well as certain information about its affiliates and the accounts over which it exercises investment discretion. A large trader would be required to update the information in its Form 13H at least annually.

After a large trader files the initial Form 13H, the SEC would assign the large trader an LTID. The Rule would require the large trader to provide this LTID to each of its registered broker-dealers and to disclose to each broker-dealer all accounts with that broker-dealer over which the large trader exercises investment discretion. In addition, a large trader would need to identify any account with the broker-dealer held by a person or entity over which the large trader exercises control. The broker-dealer would then tag each of these accounts with the large trader's LTID.

### Controlled Traders

The "large trader" definition is intended to reach the ultimate parent company or top level entity that controls other individuals or entities that individually conduct trading activity. In determining whether an entity's trading activity exceeds the identifying activity level, the Rule would require the entity to look through to any individuals (such as employees) or entities over which it exercises control and that conduct trading activity and then aggregate all of their transactions in NMS securities for the relevant periods. Control is defined generally as the power directly or indirectly to vote or sell 25% or more of an entity's voting securities or the right, in the case of a partnership, to receive 25% or more of an entity's capital upon dissolution. This definition of control is similar to the definition in Exchange Act Form 1.

For example, in a complex corporate environment, the ultimate parent company would need to include all trading activity that it or any of its departments or sub-divisions conducts, as well as all trading activity conducted by any of its direct or indirect subsidiary companies. In the investment management context, an investment adviser would need to include all trading activity conducted by the adviser or any of its employees (such as a portfolio manager) on behalf of any funds or other accounts over which the adviser or any of its employees exercises investment discretion. If a controlling entity files Form 13H and complies with all of the reporting and broker-dealer notification requirements with respect to all accounts of a large trader it controls, then the controlled large trader would not be required to file a separate Form 13H, although the Rule would not preclude it from doing so. In this case, all accounts held by a controlled large trader with a broker-dealer would be tagged with its controlling person's LTID. If a controlled large trader chooses to file a separate Form 13H, it would not receive a separate LTID, but would use the LTID assigned to its controlling person.

According to the proposing release, a large trader would not need to file Form 13H if one or more persons controlled by the large trader collectively comply with the filing and reporting requirements of the Rule with respect to all of the large trader's accounts. This provision would allow a natural person who owns a controlling interest in an entity that is a large trader to shift the burden of filing the Form 13H to the large trader entity he or she controls. The goal of this provision is to limit redundant identification of accounts and to focus the reporting obligations on institutions that operate as large traders. This provision would require that the non-filing controlling person not exercise investment discretion over any other accounts for which a filing controlled person has not satisfied the filing and reporting requirements of the Rule.

The requirement that a parent company aggregate trading activity conducted by its subsidiaries is based on the presumption that the parent company exercises investment discretion indirectly over the subsidiary's trading activity by virtue of its control over the entity. However, the SEC noted that mere ownership of an account through which the requisite volume of security transactions is conducted would not give rise to a reporting requirement if the entity that owns the account does not in fact exercise investment discretion directly or indirectly over it, such as accounts held by custodians, nominees and certain trusts.

### Broker-Dealer Obligations

Rule 13h-1 would require broker-dealers to tag each account of a large trader with the trader's LTID and to maintain certain records relating to securities transactions effected through these accounts (e.g., identifying symbol of the security, number of shares, transaction price, date, and time the transaction was executed). In addition to accounts self-identified by a reporting large trader, the Rule would require a broker-dealer to maintain records of trading activity in any accounts held by a person that the broker-dealer knows or has reason to know is a large trader but that has not complied with the identification and reporting requirements of the Rule (an "unidentified large trader"). The proposed Rule includes a safe harbor for broker-dealers that maintain policies and procedures reasonably designed to detect and identify traders that have not complied with the identification and reporting requirements of the Rule. The Rule would require broker-dealers to provide the SEC, upon request, with the trading records of any large traders or unidentified large traders. Any information obtained by the SEC pursuant to the Rule (including large trader information on Form 13H and transaction information obtained from broker-dealers) would be confidential and not subject to Freedom of Information Act requests.

### Implementation

The SEC proposes that the identification requirements applicable to large traders become effective three months after adoption of the final Rule, and that the recordkeeping and reporting requirements applicable to broker-dealers become effective six months after adoption of the final Rule. The SEC has requested comments on the Rule by June 22, 2010.