

Financial Services & Products ADVISORY

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SEC Adopts Large Trader Registration and Reporting Requirements

On July 26, 2011, the Securities and Exchange Commission (SEC, or the “Commission”) adopted new filing requirements for “large traders” and new recordkeeping, monitoring and reporting requirements for broker-dealers.¹ The new rules impact investors trading for their own accounts, advisors to managed accounts and investment managers, as well as advisors of registered investment companies and private funds, including hedge funds.

New Rule 13h-1 under the Securities Exchange Act of 1934 (the “Exchange Act”) will require persons who directly or indirectly exercise investment discretion and purchase or sell more than a specified amount of U.S. exchange-listed securities through a registered broker-dealer to register with the SEC as a large trader by filing a Form 13H (as registered, a “Large Trader”). Upon receipt of the form, the SEC will assign to each Large Trader an identification number that will uniquely and uniformly identify the trader, which must be provided to their registered broker-dealers. The broker-dealers must then comply with recordkeeping and reporting requirements based substantially on existing Exchange Act Rule 17a-25 and the Electronic Blue Sheets system,² with the addition of two data elements in connection with transactions effected through accounts of such Large Traders: the Large Trader identification number and the time when transactions in the account are executed. The broker-dealers must also report Large Trader transaction information to the SEC upon request.

The large trader reporting requirements are intended to provide the Commission with data to support its investigative and enforcement activities, as well as to facilitate its 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. The Commission has had the authority to adopt a large trader regime for 20 years. In response to the market crash of 1987 (and the less severe break of 1989), Congress passed the Market Reform Act of 1990, which, in part, added Section 13(h) to the Exchange Act.³ Section 13(h) specifically authorized the Commission to establish large trader reporting and was intended to provide the SEC with the ability to identify causes of market disruption. The Commission proposed a large trader registration and reporting regime for the third time shortly before the flash crash of May 6, 2010, in which the Dow Jones Industrial Average fell about 900 points and then recovered those losses within minutes. The flash crash and the recent financial crisis prodded the Commission to finally and unanimously adopt these new requirements.

¹ See *Large Trader Reporting*, Exchange Act Release No. 64976, File No. S7-10-10 (July 27, 2011) (“Adopting Release”).

² The SEC currently uses this system to collect transaction data from broker-dealers.

³ After the market break of 1987 it took a long time for the SEC to determine its cause. The statute’s authorization of Large Trader Reporting Rules was intended to provide the SEC with the tools needed to rapidly identify those causing market disruption in the future, and perhaps even to intervene. The Commission initially proposed rules in 1991 and again in 1994. Both proposals met a great deal of industry opposition.

Large Traders must comply with the self-identification requirements of Rule 13h-1(b) by December 1, 2011. Broker-dealers must comply with the recordkeeping, reporting and monitoring requirements by April 30, 2012. The rule's effective date is October 2, 2011 (60 days after publication in the Federal Register, which occurred on August 3, 2011).

Who Is a Large Trader?

Rule 13h-1(a)(1) defines a "large trader" as "any person that: (i) 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 security⁴ 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' or (ii) voluntarily registers as a large trader by filing electronically with the Commission Form 13H."⁵ "Identifying activity level," in turn, is defined as aggregate transactions in NMS securities that equal or exceed (i) two million shares or \$20 million during any day or (ii) 20 million shares or \$200 million during any month.

The definition of Large Trader focuses on the ultimate parent company of an entity or entities that employ or otherwise control the individuals that exercise investment discretion.⁶ Rule 13h-1(a)(4) provides that the term "investment discretion" has "the same meaning as in Section 3(a)(35) of the Securities Exchange Act of 1934."⁷ This definition encompasses a person who is "authorized to determine what securities or other property shall be purchased or sold by or for the account," as well as a person that "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"⁸ Thus, to the extent that any entity employs a person that individually or collectively with others meets the definition, for purposes of 13h-1, the entity that controls that person or persons would be a Large Trader.

To determine whether a parent company is a Large Trader, the aggregate trading activity of all entities controlled must be collected. The Commission noted that controlled entities need only produce aggregated statistics in summary form. Those summaries would be added together at the parent level to determine whether the activity level has been met with respect to the parent. If the definition is triggered, then the parent company will be required to provide information about itself and its affiliates, unless all of its affiliates comply on its behalf under Rule 13h-1(b)(3)(ii).

Rule 13h-1(a)(3) 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. For the purposes of Rule 13h-1 only, a person who directly or indirectly has the right to vote

⁴ 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). The term refers generally to exchange-listed securities, including equities and options.

⁵ Adopting Release at 16-17.

⁶ Adopting Release at 19.

⁷ *Id.* at 18.

⁸ 15 U.S.C. 78c(a)(35).

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.”⁹ The Commission considered but did not exempt investment companies or pension fund managers from the definition.

Form 13H

Traders may voluntarily file a Form 13H; however, if the thresholds are met, they must electronically file the form “promptly.”¹⁰ In addition, Large Traders must submit annual filings and amendments to Form 13H within 45 days after the end of each full calendar year and then promptly following the end of a calendar quarter if any information on the Form 13H becomes inaccurate. Large Traders who have not effected aggregate transactions at any time during the previous calendar year in an amount equal to or greater than the identifying activity level may obtain inactive status by filing for such status through a Form 13H. If a Large Trader is on inactive status and effects aggregate transactions equal to or greater than the identifying activity level, it must promptly file a Form 13H to reactivate its status. In very limited circumstances (such as dissolution or ceasing to do business) a Large Trader may submit a Termination Filing.

The Form will require disclosure of a significant amount of identifying information including:

- the types of businesses that a Large Trader or any of its affiliates engage in (e.g., broker or dealer, bank or non-bank holding company, bank, government securities broker or dealer, municipal securities broker or dealer, pension or non-pension trustee, investment adviser to one or more registered investment companies, investment adviser to one or more hedge funds or other funds not registered under the Investment Company Act, insurance company, commodity pool operator or futures commission merchant or other);
- a general description of the nature of its operations and its trading strategies and the operations and trading strategies of its Securities Affiliates (Securities Affiliates is defined as “any affiliates that exercise investment discretion over NMS securities”);
- a list of any forms that the Large Trader and its Securities Affiliates file with the SEC;
- a list of affiliates that are registered with a foreign regulator or the CFTC (and a list of their CFTC registration numbers);
- an organizational chart that identifies at least the Large Trader, its parent, all Securities Affiliates and all entities that are registered with the CFTC, as well as a description of the business and the Market Participant IDs of each such entities;
- the name and suffix of any affiliate that has been assigned a suffix as well as the Large Trader ID and suffix of any affiliate that registers separately;¹¹

⁹ Adopting Release at 24.

¹⁰ The Adopting Release states that filing within 10 days of meeting these thresholds would be considered a “prompt” response. The Adopting Release clarifies that this definition of “prompt” is limited to the filing of a 13H.

¹¹ A Large Trader may assign suffixes to the Large Trader ID in order to sub-identify affiliates or units that control an account.

- if a natural person, whether the Large Trader is self-employed;
- the name of each general or limited partner that is the owner of more than 10 percent of the financial interests in the accounts of the Large Trader;
- the executive officers, directors or trustees of the Large Trader corporation or trust;
- the jurisdiction in which the Large Trader is organized and its principal place of business; and
- a list of the broker-dealers at which the Large Trader or any of its Securities Affiliates has an account and the services provided (prime broker, executing broker or clearing broker).

As a general matter, the information that Large Traders will have to submit to the Commission will not be disclosed to the public. The Commission noted the legislative history of the Market Reform Act indicates that Congress was aware that confidential information could reveal proprietary trading strategies to competitors. Accordingly, the information that a Large Trader will be required to disclose on Form 13H or provide in response to a Commission request will be exempt from disclosure under the Freedom of Information Act (FOIA). In addition, any transaction information that a registered broker-dealer reports to the Commission under Rule 13h-1 will be exempt from disclosure under FOIA. The Commission will, however, disclose the information to Congress if asked and will comply with requests for information from any other federal department or agency requesting information for purposes within the scope of its jurisdiction, and will comply with an order of a court of the United States in an action brought by the United States or the Commission.

Registered Broker Dealer Obligations

Rule 13h-1(b)(2) requires Large Traders to disclose their Large Trader identification number, and each account to which it applies, to broker-dealers effecting transactions on their behalf. The rule then imposes further monitoring, recordkeeping and reporting obligations upon these broker-dealers if:

1. they are Large Traders;
2. they carry an account, and effect transactions in that account, on behalf of a Large Trader or a person that they know or have reason to know has met the thresholds to be a Large Trader; or
3. they effect transactions in accounts carried by a non-broker-dealer who services a Large Trader.

Registered broker-dealers will be required to monitor customer activity and flag traders that they know or have reason to know are large traders (an “Unidentified Large Trader”). This determination can be made solely through examination of the broker-dealer’s own books and records or through its own knowledge of a client and that client’s trading activities. No outside research need be conducted. Rule 13h-1(f) provides a safe harbor for broker-dealers with established policies and procedures reasonably designed to identify those clients whose transactions equal or exceed the given thresholds. These clients must subsequently be notified of their possible filing obligations under the new rule. Interestingly, however, broker-dealers are not required to stop doing business with these Unidentified Large Traders, but they must maintain records about them and provide information to the SEC upon request. For a Large Trader, broker-dealers must maintain the information currently required to be collected under the EBS system plus the Large Trader ID and trade execution times. For Unidentified Large Traders, this will also include the Unidentified Large Traders’s name, address, tax ID number and the date the account was opened.

There is no obligation to report transaction information to the SEC unless the SEC affirmatively requests information from the broker-dealer. If the SEC makes a request, broker-dealers must report the information required to be maintained for days when a day's trading equals or exceeds the "reporting activity level" of 100 shares as defined in the rule. The transaction reports are due no later than the day and time specified in the request. Normally, this should be no earlier than the opening of business on the day following the request.

Foreign Entities as Large Traders

The Adopting Release also contemplates that foreign traders may fall within the ambit of the rule. While these foreign entities may be classified as Large Traders (and thus subject to the Form 13H self-identification requirement), only SEC registered broker-dealers are subject to the monitoring, recordkeeping and reporting requirements. There is an exemption available upon application under Section 36 of the Exchange Act for large traders that cannot register due to foreign privacy laws, but the SEC notes that they do not believe that foreign laws would likely prevent a foreign entity to file a Form 13H.

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