

## SEC Adopts Large Trader Reporting Requirements

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On July 26, 2011, the SEC adopted Rule 13h-1 under the Securities Exchange Act of 1934 to require large trader registration and reporting.<sup>1</sup> The rule requires persons who directly or indirectly exercise investment discretion and purchase or sell more than a specified amount of U.S.-listed stocks and options through a registered broker-dealer to register with the SEC as large traders. These large traders must obtain a unique identification number and provide it to their registered broker-dealers. Registered broker-dealers must comply with monitoring, recordkeeping and reporting requirements with respect to registered large traders and persons who such broker-dealers know or have reason to know are large traders.

The rule will effectively require the ultimate parent companies of groups that may be large traders on a group-wide basis to develop corporate systems to enable them to identify all of their affiliates that have investment discretion with respect to U.S.-listed stocks and options. In addition, they must gather and report facts about the businesses, trading activities, regulation and brokerage relationships of the group on a combined basis. Registered broker-dealers will need to enhance their recordkeeping and reporting capabilities (using the existing Electronic Blue Sheets system) regarding large trader activity in accounts they carry, and develop systems to identify accountholders who may be “Unidentified Large Traders.”

The rule’s effective date is 60 days after publication in the Federal Register, which is expected to occur shortly. Large traders must register with the SEC within four months of the date of publication of the rule in the Federal Register, and registered broker-dealers must comply with the recordkeeping, reporting and monitoring requirements within nine months of publication of the rule.

The final large trader reporting rule modified the SEC’s original proposal to reduce incrementally the obligations of large traders and registered broker-dealers. However, it significantly reduces the obligations of U.S. registered broker-dealers with respect to foreign large traders.

The reporting system will not provide all of the data that the SEC has sought in order to reconstruct market events, such as the May 6, 2010 “flash crash.” Shortly after that market event, the SEC proposed a comprehensive, real-time data repository for tracking all information concerning customers and order events – the Consolidated Audit Trail – which it expects to consider for adoption in the near term.<sup>2</sup>

### Large Trader Obligations

#### Who Is a Large Trader?

Rule 13h-1 defines “large trader” as a person who “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 (i.e., U.S.-listed stocks and options) for or on

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<sup>1</sup> Securities Exchange Act Release No. 64976 (July 27, 2011) (Large Trader Reporting). Available [here](#). The SEC previously proposed rules to establish a large trader reporting system in 1991 and 1994 but did not take action on them.

<sup>2</sup> Securities Exchange Act Release No. 62174 (May 26, 2010), 75 Fed. Reg. 32556 (June 8, 2010) (proposed Consolidated Audit Trail). Available [here](#).

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*.<sup>3</sup>

The central definitions in determining who is a large trader are “identifying activity level,” “investment discretion” and “control.”

“**Identifying activity level**” is defined as transactions in NMS securities that equal or exceed:

- 2 million shares or \$20 million during any calendar day; or
- 20 million shares or \$200 million during any calendar month.

Purchases and sales of NMS securities will be aggregated, without offsetting or netting transactions among or within accounts, including for hedged positions.<sup>4</sup> A potential large trader must aggregate the value of all transactions in NMS securities for or on behalf of accounts over which it and its controlled persons exercise investment discretion in order to determine if it meets the identifying activity level.<sup>5</sup>

There are several exclusions from this definition, including transactions by or on behalf of an issuer, or by an underwriter on behalf of an issuer, bookkeeping entries memorializing the settlement of transactions, gifts, distributions of estates, transactions ordered by a court, rollovers of a retirement plan and transactions pursuant to an issuer benefit plan. Also excluded under the rule are transactions to effect a business combination, including a reclassification, merger, consolidation or tender offer, an issuer tender offer or other stock buyback by an issuer and a stock loan or equity repurchase agreement.

“**Investment discretion**” is defined to include authority with respect to an account “to determine what securities or other property shall be purchased or sold by or for the account,” including situations where some other person may have responsibility for such investment decisions.<sup>6</sup> The rule focuses on investment discretion, rather than ownership. Therefore, an investment adviser that exercises investment discretion over an account could be a large trader with respect to that account rather than the accountholder.

In determining whether a person is a large trader, such person must aggregate all of the qualifying NMS securities activities of persons controlled by it. The term “**control**” is defined as “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.”<sup>7</sup> In spite of comments to the SEC that the control threshold in the proposed rule was too low and could pose challenges for minority (25% or more) owners that do not have full access to information about their affiliates, the SEC did not alter the definition of control. This means that a minority investor who owns 25% or more of a large trader must

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<sup>3</sup> The rule also permits any person to voluntarily register with the SEC as a large trader and includes such voluntarily registered traders in the definition of large trader.

<sup>4</sup> With respect to U.S.-listed options transactions, only purchases and sales of the options themselves, and not purchases and sales pursuant to exercises or assignments, must be counted. Purchases and sales of equity and equity index options must be converted into share equivalents.

<sup>5</sup> Where two separate entities engage in a coordinated investment 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 such “joint” accounts towards its own identifying activity level.

<sup>6</sup> In addition, a person’s employees who exercise investment discretion within the scope of their employment are deemed to do so on behalf of the employer.

<sup>7</sup> Under the rule, a person will be presumed to have control if such person, directly or indirectly, has the right to vote or direct the vote or sale of 25% or more of a class of voting securities of an entity. There is also a presumption of control in the case of a partnership if a person has the right to receive, upon dissolution, or has contributed, 25% or more of the capital of the partnership.

ensure that such large trader complies with the large trader rule, or, if it is unable to ensure this, the minority investor must register itself as a large trader.

### Large Trader Registration, Self-Identification and Reporting

As a general rule, every person who is a large trader must register with the SEC. However, a large trader is not required to register with the SEC if (i) a person that controls the large trader complies with all of the large trader requirements, or (ii) one or more persons controlled by such large trader collectively comply with the large trader requirements. In the latter case, one or more control persons must aggregate all of the collective activities of the group, even if the other members of the group do not individually reach the identifying activity level.

It is possible to voluntarily register as a large trader even if the trading activity threshold is not met. In some instances, voluntary registration may potentially avoid some of the challenges associated with monitoring trading levels and determining whether the trading activity threshold has been reached, particularly for large, complex institutions.

Large traders must register with the SEC by filing Form 13H via EDGAR “promptly” after reaching the threshold trading level described above. The adopting release indicates that while “promptly” depends on the facts and circumstances, under normal circumstances initial registrations (and reactivations, discussed below) filed within ten days after the large trader crosses the threshold trading level would ordinarily be sufficiently prompt.

Upon receipt of Form 13H, the SEC will issue the large trader a unique large trader identification number (“**large trader ID**”). A large trader must disclose its large trader ID to the registered broker-dealers that effect transactions on its behalf, and must disclose to each such registered broker-dealer all accounts held at that broker-dealer to which the large trader ID applies. The rule prohibits persons from disaggregating accounts for the purpose of avoiding identification as a large trader.

Large traders who are registered with the SEC must promptly respond to requests from the SEC for additional identifying or clarifying information that would allow the SEC to further identify the large trader and all accounts through which the large trader effects transactions.

A large trader may assign suffixes to the large trader ID to sub-identify persons, affiliates, departments or units that directly control an account. The SEC could then request information directly from the person or area identified by the suffix.

### New Form 13H

Form 13H requires a significant amount of identifying information regarding large traders, including, among other things:

- the type of business of the large trader and any of its affiliates (e.g., broker, dealer, bank, investment adviser or hedge fund);
- a general description of the operations and trading strategies of the large trader and any affiliates that exercise investment discretion over NMS securities (such affiliates are defined in Form 13H as “**Securities Affiliates**”);<sup>8</sup>
- a list of any forms that the large trader and its Securities Affiliates file with the SEC;

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<sup>8</sup> Whether an entity is a Securities Affiliate does not depend upon the amount of trading activity by such entity.

- a list of affiliates that are registered under the Commodity Exchange Act or otherwise registered with the CFTC, and a list of their registration numbers;
- whether the large trader or any of its Securities Affiliates are regulated by a foreign regulator and, if so, a list of such entities and their regulators;
- an organizational chart that identifies 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 MPIDs of each such entity;
- the name and suffix of any affiliate that has been assigned a suffix;
- the large trader ID and suffix of any affiliate that registers separately;
- 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% 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 (e.g., prime broker, executing broker or clearing broker).

The requirements of Form 13H are somewhat less onerous for large traders than those that were in the proposed Form 13H. For example, a large trader must list the names of the broker-dealers at which the large trader has an account, rather than list all of the brokerage account numbers and names over which the large trader exercises investment discretion.

Large traders must update Form 13H annually and amend the form on at least a quarterly basis if necessary to correct information that becomes inaccurate. A large trader, such as an infrequent trader, may also use Form 13H to file for inactive status if it does not reach the identifying activity level for a full calendar year after registering.

Form 13H will be confidential and exempt from Freedom of Information Act requests.

## Registered Broker-Dealer Obligations

SEC-registered broker-dealers must comply with new monitoring, recordkeeping and reporting responsibilities with respect to large traders who maintain accounts with them. The recordkeeping and reporting requirements are based substantially on existing Exchange Act Rule 17a-25 and the Electronic Blue Sheets system, which the SEC currently uses to collect transaction data from broker-dealers. However, the rule requires recordkeeping and reporting of two new data fields: the large trader ID and the execution time of the transaction. As a result, registered broker-dealers will need to enhance their existing Electronic Blue Sheets infrastructure and adopt new policies and procedures. In addition, broker-dealers will have to develop monitoring capabilities to detect potential “Unidentified Large Traders” across multiple accounts.

An “**Unidentified Large Trader**” is a person who has not complied with the large trader registration and self-identification requirements and that a registered broker-dealer knows or has reason to know is a large trader based on such person’s transactions in NMS securities effected by or through such broker-dealer. If a registered broker-dealer effects transactions for an intermediary who carries an omnibus account that exceeds the identifying activity level, the broker-dealer must treat the intermediary as an Unidentified Large Trader, unless the intermediary represents that the individual subaccounts that are part of the omnibus account do not exceed the identifying activity level. The registered broker-dealer

does not need to seek information about the holders of the sub-accounts, even if the broker-dealer suspects that the holder is a large trader.

### **Monitoring**

Registered broker-dealers have a responsibility to monitor their customers' accounts for compliance with the large trader registration requirement. The rule provides registered broker-dealers with a safe harbor for the monitoring requirement if the registered broker-dealer does not have actual knowledge that a person is a large trader and establishes policies and procedures reasonably designed to:

- detect and identify Unidentified Large Traders;
- treat any persons identified as Unidentified Large Traders as such; and
- inform Unidentified Large Traders of their potential obligations under Rule 13h-1.

In the adopting release, the SEC emphasizes the limited nature of the monitoring requirement. First, the SEC states that in determining whether a person may be a large trader, registered broker-dealers need not look beyond the identifying information available on their own books and records and do not have a duty to make further inquiries of their customers or of other broker-dealers. They will need to aggregate trading in different accounts at the broker-dealer for the entity and its affiliated accounts. Second, the SEC assured broker-dealers that they need not halt trading with Unidentified Large Traders; instead, they must keep records of such traders and report that information to the SEC upon request. Third, registered broker-dealers are not required to precisely determine who is a large trader. For example, if a customer exceeds the identifying activity level, the broker-dealer need only treat the customer as an Unidentified Large Trader and need not determine if the customer or transaction is subject to an exclusion or exemption.

### **Recordkeeping**

For large trader transactions, a registered broker-dealer must maintain a record of the large trader ID and trade execution times, in addition to all the information currently required to be collected by the Electronic Blue Sheets system. A registered broker-dealer also must maintain records of an Unidentified Large Trader's name, address, tax identification number(s) and the date its account was opened, in addition to the other information required to be recorded about large traders.

All records regarding large traders and Unidentified Large Traders must be available on the morning after the day the transactions were effected (including Saturdays and holidays). Because the current Electronic Blue Sheets system does not require that broker-dealers be able to provide information to the SEC on a next-day basis, many registered broker-dealers will need to make changes to their data-collection systems to satisfy this availability standard.

### **Reporting**

The SEC noted that in general, the reporting deadline will be no earlier than the opening of business of the day after a request for information is made. There is no obligation to report to the SEC unless the SEC affirmatively requests information from the broker-dealer. Upon request, a registered broker-dealer must report to the SEC via the Electronic Blue Sheets system the information required to be maintained (described above) for transactions equal to or greater than 100 shares of NMS securities.

### **Foreign Entities**

Rule 13h-1 applies to large traders who "use the U.S. jurisdictional means" to effect transactions in NMS securities and therefore requires certain foreign large traders to register with the SEC. The duties of foreign large traders that use foreign intermediaries with omnibus accounts at registered broker-dealers are somewhat ambiguous under the rule. While the rule requires large traders to disclose their large

trader IDs to registered broker-dealers that effect transactions for them, certain foreign large traders may not have any accounts or direct relationships with the ultimate registered broker-dealers effecting their transactions. Thus, it is far from clear how such foreign large traders are to disclose their large trader IDs to registered broker-dealers. In addition, Form 13H requires large traders to list the broker-dealers who carry an account for them, but the adopting release specifies that large traders need only list “registered” broker-dealers that carry their accounts. It is unclear whether and how foreign large traders who use foreign intermediaries to access the U.S. equities markets, and thus do not have accounts at registered broker-dealers, would need to complete this part of the form.

Any foreign entity that cannot register as a large trader due to foreign privacy laws could seek an exemption pursuant to Section 36 of the Exchange Act, though the SEC notes that it believes it is unlikely that a foreign jurisdiction’s laws would preclude the large trader from completing Form 13H. If a foreign entity, or a domestic entity, obtains an exemption from registration, registered broker-dealers would still need to tag these entities as Unidentified Large Traders and record and report their trades.

Only SEC-registered broker-dealers are subject to the rule’s monitoring, recordkeeping and reporting requirements. Foreign intermediaries who carry accounts for foreign entities do not have a duty to obtain or disclose the identity of their ultimate customers to registered broker-dealers, nor do registered broker-dealers have a duty to identify the ultimate customers of such foreign intermediaries.

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