SEC Adopts Large Trader Reporting Rule

Recently, the Securities and Exchange Commission (SEC) adopted new Rule 13h-1 (the Rule) and Form 13H under existing Section 13(h) of the Securities Exchange Act of 1934 (the Exchange Act). The Rule will require large traders (defined below) to register with the SEC and identify themselves as such to broker-dealers executing their transactions. Additionally, the Rule will require registered broker-dealers to maintain transaction records for each large trader and report those transactions to the SEC upon request. The Rule was adopted pursuant to the SEC’s authority under the Market Reform Act of 1990.

Although the Rule was proposed prior to the “flash crash” of May 6, 2010, the SEC stated in the adopting release that that incident “emphasized the importance of enhancing the Commission’s ability to quickly and accurately analyze and investigate major market events, and has highlighted the need for an efficient and effective mechanism for gathering data on the most active market participants.” In an SEC press release, SEC Chairman Mary L. Schapiro said, “This new rule will enable us to promptly and efficiently identify significant market participants and collect data on their trading activity so that we can reconstruct market events, conduct investigations, and bring enforcement actions as appropriate.”

The Rule will become effective on Oct. 3, 2011. Large traders will be required to file Form 13H on or before Dec. 1, 2011. Broker-dealers must begin to maintain records, monitor and report large trader activity by April 30, 2012.

Entities that may fall within the definition of large traders should consider whether they will be required to register and also whether to take advantage of the voluntary registration provisions of the Rule. This includes investment advisers, hedge funds, broker-dealers, banks and foreign entities. These entities, and the broker-dealers that execute their securities transactions, should also consider the recordkeeping and reporting requirements of the Rule and begin to develop compliance systems in anticipation of the Rule becoming effective.
Definition of a Large Trader

The Rule defines a large trader as a person who directly or indirectly exercises investment discretion over transactions in NMS securities1 that equal or exceed either:

1. 2 million shares or $20 million during any calendar day, or
2. 20 million shares or $200 million during any calendar month.

These thresholds under the Rule constitute the “identifying activity level” specified in Section 13(h).2

The adopting release for the Rule states that, in the case of registered and unregistered investment companies, the investment adviser — and not the investment company — exercises investment discretion and thus may be required to register as a large trader. Pension fund managers also may be defined as large traders. The Rule makes a notable exception from the definition of large trader for the actual transfer of the basket of securities between an authorized participant and an exchange-traded fund.

Aggregation of Transactions

In determining large trader status, a person must aggregate the accounts over which he has investment discretion with accounts over which any entity controlled by such person exercises investment discretion. This requirement for aggregation places a focus on the ultimate parent company of entities under common control. Control results from the direct or indirect “power to direct or cause the direction of the management and policies of a person,” and control is presumed with a 25 percent or greater ownership interest. If the relevant thresholds are met under the Rule, the parent company must report under the Rule unless all of its affiliates comply on its behalf.

Voluntary Registration as a Large Trader

Without regard to the above identifying activity levels, a person may voluntarily register as a large trader, and thus obviate the need to monitor its transactions in NMS securities on an ongoing basis.

Requirements For Large Traders Under the Rule

Timing of Registration and Filings

Large traders must register with the SEC by filing Form 13H “promptly” after first effecting transactions that reach the identifying activity level and annually thereafter, within 45 days after the calendar year-end. In the adopting release, the SEC notes that the term

---

1 The Rule incorporates the definition of “NMS security” from Regulation NMS, which defines “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.” The term refers generally to U.S. exchange-listed securities, including equities and options.

2 The Rule definition of large trader is consistent with Section 13(h). Section 13(h) defines a large trader as “every person who, for his own or an account for which he exercises investment discretion, effects transactions for the purchase or sale of any publicly traded security or securities by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of a national securities exchange, directly or indirectly by or through a registered broker or dealer in an aggregate amount equal to or in excess of the identifying activity level.”
“promptly” refers to an expectation that in normal circumstances these filings would be made within 10 days. Large traders must also submit an amended filing by the end of a calendar quarter if information in a previous filing becomes inaccurate.

A large trader may terminate its status in limited circumstances — for example, by reporting the termination of its operations. If a large trader registers as such, but subsequently does not meet the identifying activity level for a full calendar year, it may file for “Inactive Status,” and will not need to file for “Reactivated Status” until it meets that level again (at which point, it must file promptly for reactivation).

**Form 13H**

Form 13H is a six-page form that must be filed on EDGAR. The form requires large traders to provide certain information about their operations, including a description of trading strategies. The form also requests, among other things, the following information:

> An organizational chart that identifies the large trader, any parent company, securities affiliates\(^3\) and affiliates registered with the Commodity Futures Trading Commission (CFTC);

> Information relating to other filings of the large trader and its security affiliates with the SEC and CFTC; and

> A list of broker-dealers at which the large trader or its securities affiliates has an account.

**Identification Number and Self-Identification to Broker-Dealers**

Once a large trader has registered with the SEC, the SEC will then issue a unique large trader identification number (LTID), which the large trader must disclose to the registered broker-dealers effecting transactions on its behalf. This number will allow the SEC to identify traders and track their trading activity.

**Requirements For Broker-Dealers Under the Rule**

**Monitoring, Recordkeeping and Reporting Requirements for Broker-Dealers**

In addition to reporting requirements already in place for broker-dealers, the Rule will impose requirements on registered broker-dealers that receive LTID disclosures from large traders to maintain records of such traders’ transactions.

A broker-dealer must also monitor and maintain records of transactions by persons that have not registered as large traders but that the broker-dealer knows or has “reason to know” are large traders. (These persons are labeled “unidentified large traders.”) However, a broker-dealer does not need to look beyond its own books and records to monitor transactions effected through other broker-dealers. The Rule provides a safe harbor for a broker-dealer who has no actual knowledge that a person is a large trader if that broker-dealer has established policies and procedures reasonably designed to:

---

\(^3\) An affiliate is any person that directly controls, indirectly controls, is under common control with, or is controlled by the large trader. A “securities affiliate” is an affiliate of the large trader that exercises investment discretion over NMS securities.
(1) Identify customers whose transactions with the broker-dealer equal or exceed the identifying activity level; and

(2) Treat those customers as unidentified large traders and notify them of their potential reporting obligations under the Rule.

Notably, the Rule does not require broker-dealers to cease business with unidentified large traders.

Broker-dealers must submit transaction records of large traders and unidentified large traders when requested by the SEC.

Access to Data

Under the Rule, required records must be provided to the SEC upon request on the morning after the day a transaction is effected, including on Saturdays and holidays. Information will be reported on the existing “Electronic Blue Sheets” system, which is currently used by broker-dealers to report trade information.

Confidentiality of Information Provided Under the Rule

In the adopting release, the SEC notes that information provided pursuant to the Rule will be kept confidential from the public and will be exempt from disclosure under the Freedom of Information Act. However, the SEC may be required to disclose information to Congress, federal departments and agencies acting within the scope of their jurisdiction, or pursuant to a federal court order.

Investment Management Group

For more information about the matters discussed in this Alert, please contact your regular Drinker Biddle lawyer or any member of our Investment Management Group.

Partners, Of Counsel and Counsel

Gary D. Ammon
(215) 988-2981
Gary.Ammon@dbr.com

Bruce L. Ashton
(310) 203-4048
Bruce.Ashton@dbr.com

John W. Blouch
(202) 230-5422
John.Blouch@dbr.com

Jeffrey Blumberg
(312) 569-1106
Jeff.Blumberg@dbr.com

Stephen T. Burdumy
(215) 988-2880
Stephen.Burdumy@dbr.com

Summer Conley
(310) 203-4055
Summer.Conley@dbr.com

Mark F. Costley
(202) 230-5108
Mark.Costley@dbr.com

Joshua B. Deringer
(215) 988-2959
Joshua.Deringer@dbr.com

Bruce W. Dunne
(202) 230-5425
Bruce.Dunne@dbr.com

Glenn E. Ferencz
(312) 569-1246
Glenn.Ferencz@dbr.com

Stephen D.D. Hamilton
(215) 988-1990
Stephen.Hamilton@dbr.com

Veena K. Jain
(312) 569-1167
Veena.Jain@dbr.com

Michelle M. Lombardo
(215) 988-2867
Michelle.Lombardo@dbr.com

Michael P. Malloy
(215) 988-2978
Michael.Malloy@dbr.com

David M. Matteson
(312) 569-1145
David.Matteson@dbr.com

Diana E. McCarthy
(215) 988-1146
Diana.McCarthy@dbr.com

Nancy P. O’Hara
(215) 988-2699
Nancy.OHara@dbr.com

Mary Jo Reilly
(215) 988-1137
MaryJo.Reilly@dbr.com

Fred Reish
(310) 203-4047
Fred.Reish@dbr.com

Audrey C. Talley
(215) 988-2719
Audrey.Talley@dbr.com