

## SEC RELEASES FINAL RULE ON LARGE TRADER REPORTING

August 4, 2011

To Our Clients and Friends:

On July 26, 2011, the U.S. Securities and Exchange Commission (the “SEC”) adopted Rule 13h-1<sup>1</sup> (the “Rule”) under Section 13(h) of the U.S. Securities Exchange Act of 1934, as amended (the “Exchange Act”). The Rule was adopted more than a decade after the SEC was given authority by Congress to establish large trader reporting requirements. In the adopting release, the SEC stated that the Rule is part of the SEC’s ongoing review of the U.S. securities market structure in light of rapid changes in trading strategy and practices. The Rule establishes a reporting system for “large traders” to assist the SEC in identifying large market participants and monitoring their trading activity. The information collected will be used by the SEC, to assess the impact of such traders on the securities markets, to reconstruct trading activity following periods of market instability and to assist in enforcement efforts of the SEC.

The Rule requires “large traders” to self-identify and file Form 13H with the SEC, which will then issue to each such person a Large Trader Identification Number (“LTID”). In general, the Rule focuses on identifying the ultimate parent company of an entity or entities that employ or control the individuals exercising investment discretion. An entity such as an investment adviser will be required to aggregate trading activity across the accounts over which it exercises investment discretion.

A large trader must disclose its LTID to registered broker-dealers through which it effects trades. These broker-dealers will, in turn, be required to use the LTID system to track and maintain certain information pertaining to transactions made under LTID-linked accounts that are under the investment discretion of such large trader. Upon the SEC’s request, registered broker-dealers will be required to provide the SEC with the collected transaction data.

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<sup>1</sup> *The adopting release for the Rule issued by the SEC (which includes the related Form 13H) is available at <http://sec.gov/rules/final.shtml>*

The Rule will become effective on October 3, 2011. Large traders will have until December 1, 2011 to comply with the identification requirements, while registered broker-dealers will have until April 30, 2012 to comply with the requirements for monitoring, recordkeeping and reporting.

## LARGE TRADER

### Who Can Become a Large Trader?

The Rule 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.”

A person may also voluntarily register as a large trader. The SEC suggests in the adopting release that a person may desire to voluntarily register as a large trader as the trader nears the identifying activity level so as to reduce the need to actively monitor its trading levels at such time.

A key term in the definition is “investment discretion.” The Rule refers to Section 3(a)(35) of the Exchange Act in defining investment discretion, which Section 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.” Rule 13h-1(a)(4) provides that a “person’s employees who exercise investment discretion within the scope of their employment are deemed to do so on behalf of such person,” so that an entity that employs a natural person who, individually or together with others, is a large trader for purposes of the Rule will also be a large trader. This definition may raise some interpretive questions. In case of a private fund formed as a limited partnership, for example, the general partner has the ultimate responsibility for all trading activities of the fund, but the investment manager has the day-to-day responsibility for fund management, including trade execution. Also, such fund frequently engages an unrelated asset manager as a sub-manager that is responsible for a portion of the assets of the fund and may have an independent investment committee that is responsible for certain investment decisions (such as a large investment or transaction raising a potential conflict of interest issue). Under the Rule, such fund will likely entail multiple large traders relating to a single account.

### Identifying Activity Level

The identifying activity level is defined under the Rule as “aggregate transactions in NMS securities” that are equal to or greater than:

- during a calendar day, 2 million shares or shares with a fair market value of \$20 million; or
- during a calendar month, 20 million shares or shares with a fair market value of \$200 million.

An NMS (national market system) security is defined pursuant to Rule 600 of Regulation NMS under the Exchange Act 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.” Generally, NMS securities are stock and options listed on national securities exchanges.

The Rule defines the term “transaction” as “all transactions in NMS securities, excluding exercise or assignment of option contracts,” except for certain specified transactions. With respect to options, only purchases and sales of options need to be counted but transactions in underlying securities pursuant to exercise or assignment of options need not be counted. The volume and value of options purchased and sold is determined by reference to the securities underlying each option. For example, the transaction volume for an options transaction on a single security would be calculated as the number of options purchased (or sold) multiplied by the number of shares represented by each option. For example, 100 ABC call options will be counted as 10,000 ABC stock, where a single option is on 100 ABC shares. With respect to index options, the market value is computed by multiplying the number of contracts purchased (or sold) by the market price of the options and the applicable index multiplier.

When calculating a trader’s activity to determine whether such activity exceeds the identifying activity level, a trader must aggregate the volume or fair market value of transactions in securities and the volume or fair market value of the securities underlying transactions in options on securities (including options on a group or index of securities). Transactions in index options are thus aggregated with transactions in securities on the basis of the fair market value of the underlying securities. Transactions in index options are not required to be “burst” into share equivalents for each of the underlying component equities. The Rule prohibits any sort of offsetting or netting of purchase and sale transactions (including transactions effected for hedging purposes), or netting among or within accounts.

For the sole purpose of determining whether a person is a large trader, the Rule exempts certain types of transactions that the SEC has indicated do not warrant scrutiny because they are typically entered into for reasons other than arm's-length trading in the secondary market and are not indicative of the associated exercise of investment discretion. (However, these transactions are still subject to the large trader reporting system and any such transactions effected through the accounts of large traders must be disclosed to the SEC upon its request.) These transactions include:

- a 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;
- a transaction that is part of an offering of securities by an issuer or an underwriter or agent on such issuer's behalf, except for an offering of securities effected through a national securities exchange;
- a transaction that constitutes a gift;
- a transaction by a court-appointed executor, administrator or fiduciary involving a distribution from a decedent's estate;
- a transaction effected pursuant to a court order or judgment;
- a transaction pursuant to a rollover of qualified plan or trust assets subject to Section 402(a)(5) of the Internal Revenue Code;
- a transaction between an employer and employee 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; and
- a transaction to effect a business combination (including a reclassification, merger, consolidation or tender offer subject to Section 14(d) of the Exchange Act), an issuer tender offer or other stock buyback by an issuer, or a stock loan or equity repurchase agreement.

In addition to the above-listed transactions, the SEC may by order exempt, upon specified terms and conditions or for a stated period, any person or class of persons or any transaction or class of transactions from the provisions of the Rule to the extent such exemption is consistent with the purposes of the Exchange Act. For example, while not specifically listed, the SEC noted in the adopting release that it will count toward the identifying activity level trading activity in the

secondary market relating to the acquisition or disposition of securities in connection with the creation or redemption of ETF shares, but not the transfer of such securities between an ETF and an “authorized participant” in the ETF as such transfer is not an arm’s-length securities transaction in the secondary market.

#### CONTROLLED AND CONTROLLING LARGE TRADERS

A large trader is not required to comply separately with the large trader identification requirements if the person or entity that controls such large trader identifies itself to the SEC and complies with the Rule. In such cases, all accounts held by a controlled large trader with a broker-dealer would be tagged with the LTID of its controlling person or entity.

Control is defined broadly in this context 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.” Notably, a presumption of control is placed on those entities or persons that have the power directly or indirectly to vote or sell 25% or more of any class of an entity’s voting securities or, in the case of a partnership, has contributed to (or has the right to receive upon dissolution) 25% or more of an entity’s capital.

To determine whether the controlling entity’s trading activity exceeds the identifying activity level that would necessitate its own registration as a large trader, the Rule provides that the controlling entity must aggregate the trading activity in NMS securities of any individuals or entities over which it exercises control for the relevant periods. In other words, even for a controlling entity whose subsidiaries’ separate trading activities would not require those subsidiaries to individually register, the controlling entity must register as a large trader if the combined relevant trading activities of its subsidiaries reach the identifying activity level. However, such a controlling entity is not required to register as a large trader in a case where it does not conduct direct trading activities of its own and all the trading entities that it controls have identified themselves to the SEC in compliance with the Rule.

#### FORM 13H

Under the Rule, a large trader must file a Form 13H. Form 13H requires a large trader to disclose certain information about its business, including its identity and organizational structure, its regulatory status and the identities of certain of its affiliated persons and the broker-dealers it uses. Additional information is required pursuant to Form 13H for large traders that are registered with the Commodity Futures Trading Commission or regulated by a foreign regulator. Unlike the draft Form 13H initially proposed by the SEC, the final

Form 13H does not require that a large trader disclose the account numbers through which it and certain of its affiliates effect trades.

Form 13H provides for six types of filings, each to be filed by a large trader at such times as described below.

- **Initial Filing.** A large trader must file Form 13H electronically with the SEC promptly after first effecting securities transactions that reach the identifying activity level.
- **Amended Filing.** A large trader must update the information in its Form 13H annually, within 45 days after the end of each calendar year.
- **Amended Filing.** A large trader is required to make an amended Form 13H filing promptly following the end of any calendar quarter (or more frequently than quarterly at its discretion) if any information contained in its existing filing becomes inaccurate.
- **Inactive Status.** If a large trader does not reach the threshold trading level in a calendar year, the trader may file a Form 13H claiming inactive status and be relieved from further filing obligations. A large trader claiming inactive status may also request that its broker-dealers cease to maintain records of its transactions by LTID.
- **Reactivated Status.** If, after filing for inactive status, a large trader's subsequent trading activities again reach the identifying activity level, such large trader must promptly file a Form 13H for reactivated status and notify its broker-dealers promptly regarding its change in status after filing for reactivated status.
- **Terminated Status.** A large trader that has ceased operations may elect to become inactive by filing a Form 13H indicating its terminated status.

The Rule does not define “promptly” in respect of the timing for initial and reactivated Form 13H filings; however, the SEC’s adopting release indicates that it would be appropriate, under normal circumstances, for such filings to be made within 10 days after the large trader effects aggregate transactions reaching the identifying activity level.

After a large trader files the initial Form 13H, the SEC will assign the large trader a unique LTID. The Rule requires the large trader to provide this LTID to each of its registered broker-dealers and to identify to each broker-dealer all accounts with that broker-dealer over which the large trader exercises investment discretion. The broker-dealer is then required to

tag each of these accounts with the large trader's LTID as a means to facilitate monitoring and recordkeeping of NMS securities transactions executed under those accounts.

Form 13H allows a large trader to apply LTID suffixes to further identify sub-groups within a large trader. The SEC encourages large traders to use such LTID suffixes in order to facilitate more efficient tracking of trading activity within each sub-group and a better ability to respond to SEC information requests.

The SEC will generally treat information submitted by large traders on Form 13H and collected from registered broker-dealers pursuant to the Rule as confidential. However, the SEC may be compelled to disclose such confidential information if requested by Congress, any Federal department or agency requesting information for purposes within the scope of its jurisdiction, or any court of the United States in an action brought by the United States or the SEC.

## OBLIGATIONS OF REGISTERED BROKER-DEALERS

### Recording and Reporting

The Rule requires registered broker-dealers to maintain certain transaction data relating to the securities effected through LTID-linked accounts. The types of data required are largely similar to the information required under the existing Electronic Blue Sheets (EBS) reporting system whereby registered broker-dealers are required to electronically file certain trading information with the SEC. The trading information that must be maintained by registered broker-dealers pursuant to the Rule includes the following data for all transactions:

- clearing house number or alpha symbol of the broker or dealer submitting the information and equivalent information for the entity or entities on the opposite side of the transaction;
- identifying symbol assigned to the security;
- execution dates and times;
- number of shares (or option contracts) traded in each specific transaction; whether it was a purchase, sale or short sale; and (if an option contract) whether the transaction was a call or put option, an opening purchase or sale, a closing purchase or sale, or an exercise or assignment;
- transaction price;

- account number;
- identity of the exchange or other market center where the transaction was executed;
- a designation of whether the transaction was effected for a customer or was a proprietary transaction;
- identifiers indicating transfers from and to accounts at other registered broker-dealers;
- identifiers indicating transfers from and to other accounts at the reporting broker-dealer;
- if a transaction was processed by a depository institution, the identifier assigned to the account by the depository institution; and
- unless the “unidentified large trader” provisions noted below apply, the LTID(s) associated with the relevant account(s).

Broker-dealers must maintain the collected data for a period of three years, and during the first two years in an accessible place. A broker-dealer need not maintain records of transactions by a large trader claiming inactive status on Form 13H.

Upon the request of the SEC, every registered broker-dealer that (A) carries an account for a large trader or an “unidentified large trader” (as described below), (B) effects transactions for an account maintained by a large trader or an unidentified large trader with a non-broker-dealer, or (C) is itself a large trader (with proprietary account(s)), is required to report electronically to the SEC all information described above for all transactions effected directly or indirectly by or through such accounts equal to or greater than the “reporting activity level.” The Rule defines the reporting activity level to include (i) each transaction in NMS securities, effected in a single account during a calendar day, that is equal to or greater than 100 shares, (ii) any transaction in NMS securities for fewer than 100 shares, effected in a single account during a calendar day, that a registered broker-dealer may deem appropriate, or (iii) such other amount that may be established by order of the SEC from time to time. Such information is required to be available on the morning after the day on which the relevant transactions were effected.

#### Monitoring of Unidentified Large Traders

In addition to those accounts that have been self-reported by a large trader, a registered broker-dealer must monitor those accounts of customers that the broker-dealer knows or has a reason to know would meet the large trader activity level but that have not been self-

identified by the relevant customers to the SEC pursuant to the Rule. A holder of such an account is known as an “unidentified large trader,” and a broker-dealer is required to maintain, in addition to the transaction information identified above, the name, address, date of account opening and tax identification number(s) for each such unidentified large trader. The Rule requires broker-dealers to provide the SEC, upon its request, with the trading records of unidentified large traders.

Broker-dealers may rely on a safe harbor in connection with monitoring unidentified large traders. Such safe harbor provides that a registered broker-dealer will not be deemed to know or have reason to know that a person is an unidentified large trader if it (i) does not have actual knowledge that a person is a large trader and (ii) maintains policies and procedures reasonably designed to identify the large traders that have not complied with the large trader identification and reporting requirements, treat persons so identified as large traders as unidentified large traders pursuant to the Rule and inform any such person so identified of its own potential obligations under the Rule.

In its adopting release, the SEC emphasizes the limited scope of the unidentified large trader monitoring obligation of broker-dealers. First, a registered broker-dealer is only required to take into account transactions effected through such broker-dealer and not any accounts at other broker-dealers to determine whether such broker-dealer has a reason to know of its customer’s large trading status. The broker-dealer is not required to determine the customer’s precise large trader status (*i.e.*, whether it is subject to any exemptions or exclusions). Moreover, the broker-dealer may continue to trade with unidentified large traders but must comply with the Rule’s requirements to maintain and report information to the SEC in respect of such unidentified large traders.

#### Application to Non-U.S. Entities

A non-U.S. large trader that uses U.S. broker-dealers to effect transactions in NMS securities is subject to the Rule, and registered broker-dealers are required to maintain and report information pursuant to the Rule for such non-U.S. large traders. The adopting release addresses the common situation where non-U.S. traders utilize non-U.S. intermediaries to effect their trades. In such situations, a U.S.-registered broker-dealer is required to treat such non-U.S. intermediary as it would any other client and collect the information specified by the Rule if such non-U.S. intermediary is a large trader or an unidentified large trader. However, a registered broker-dealer need not identify the ultimate customers of such foreign intermediaries and it is the responsibility of the foreign intermediaries themselves to bear the principal burden of determining its large trader status. A foreign large trader may also apply

to the SEC for an exemption from the Rule if it cannot comply with the large trader reporting requirements due to foreign privacy laws.

A non-U.S. broker-dealer is not required to comply with the broker-dealer requirements of the Rule, but may be subject to the Rule's large trader identification requirements if it qualifies as a large trader in respect of its own trading activities.

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