Morgan Lewis

alert

investment management lawflash

www.morganlewis.com

SEC Adopts Large Trader Reporting System

August 2, 2011

On July 26, two decades after it first proposed adoption of a large trader reporting system, the Securities and Exchange Commission (SEC) voted to adopt Rule 13h-1 (the Rule) under the Securities Exchange Act of 1934 (Exchange Act). The Rule builds on the existing electronic blue sheets (EBS) system developed jointly by the SEC and the self-regulatory organizations to require broker-dealers to provide customer and proprietary transaction trading information to the securities regulators in connection with surveillance and enforcement inquiries.[1]

The Rule requires any person that is a "Large Trader," including individuals managing their own accounts, to register with the SEC using Form 13H and obtain an identification number from the SEC. After receipt of an identification number, Large Traders must disclose their identification number to all executing and clearing registered broker-dealers through whom they transact in NMS securities.[2] They must also update their Form 13H on an annual basis and, if the information contained therein changes in any way, must file an updated Form 13H by of the end of the quarter in which the change occurs.

Although Form 13H registration is required when specified trading thresholds are met, traders may avoid the need to monitor their own trading levels or to aggregate trading activity across accounts they manage and across entities under common control by voluntarily registering with the SEC. Voluntary registration is allowed whether or not the target trading levels have been hit and the Rule does not impose any deregistration process in the event that a voluntarily registered Large Trader never meets the required trading levels. As a result, a trader can fairly easily ensure full compliance with the Rule. All registration information provided to the SEC by Large Traders is confidential and exempt from disclosure under the Freedom of Information Act.

The Rule requires broker-dealers that receive Large Trader identifiers from customers to use the identifiers to collect detailed information regarding transactions effected or cleared through them by the Large Traders and to provide this information to the SEC upon request. In addition to the Large Trader identifier and the time of trade execution, broker-dealers must retain all of the same information they currently are required to retain in connection with the EBS system.

1. *See* 17 CFR 240.17a-25.

2. NMS Security is defined in Rule 600(b)(46) under the Exchange Act (within Regulation NMS) 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."

Most significantly, under the Rule, broker-dealers must also track and retain for those customers that are **not** registered as Large Traders—but **should be** registered—the same detailed trade information as they do for registered Large Traders, plus additional identifying information. Broker-dealers apparently could have liability for failure to detect and track these "Unidentified Large Traders," unless they adopt policies and procedures reasonably designed to identify potential Unidentified Large Traders based on their account name, customer tax ID, and other available information, and then retain and provide to the SEC, upon request, transaction information for these persons.

The Rule becomes effective 60 days after publication in the *Federal Register* (which is expected shortly). Large Traders will be required to register within two months of effectiveness and broker-dealers will be required to be in compliance seven months after effectiveness.

LARGE TRADER STATUS AND OBLIGATIONS

Who Is a "Large Trader"? "Large Trader" is defined as a person who, directly or indirectly, through the exercise of "investment discretion,"[3] effects transactions in NMS securities that exceed, in the aggregate, (i) $20 million fair market value or 2 million shares *on any calendar day*, or (ii) $200 million fair market value or 20 million shares *over the course of any calendar month.* Investment discretion is defined broadly to include all types of discretion, including standing orders, so long as the discretion involves the selection of which NMS securities to purchase or sell. Large Trader status applies to an adviser or agent having trading discretion over an account and not to the account or to the beneficial owner of the account.

The Rule applies to any type of agent having investment discretion over an account, including a broker-dealer, and requires them to register as a Large Trader if trigger levels are met. Investment discretion appears to include more limited forms of discretion, such as standing orders.[4] Large Traders include regulated and unregulated entities as well as foreign persons. Unlike the requirements of Schedule 13F, individuals trading for their own account or for an LLC or other entity holding their own assets are subject to the registration requirements of the Rule.

In the case of companies that have multiple affiliates (or controlled entities) that satisfy the definition of "Large Trader," the company may register on a consolidated basis or individual Large Trader affiliates may separately register (i) on behalf of the parent applying for a single firm identifier, or (ii) each in its own name, seeking separate identifiers. If its subsidiaries file separately, the parent does not need to register. Large Traders must attach an organizational chart to Form 13H on which registration is made and identify their parent company (if applicable), as well as any other Large Trader affiliate. To the extent desired, a company may assign suffixes to their identification numbers to identify persons,

3. The Rule defines "investment discretion" by referencing the definition set forth in Section 3(a)(35) of the Exchange Act, namely, if a person, either directly or indirectly, "(A) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account, . . . or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the [SEC], by rule, determines . . . should be subject to the operation of the provisions of [the Exchange Act] and the rule and regulations thereunder," then such person is deemed to exercise investment discretion.

4. The Rule references Section 3(a)(35) of the Exchange Act for the definition of investment discretion. That definition would not appear to include time and price discretion but would include any authority to decide which securities are purchased or sold by or for an account. As a result, the definition would include a standing order given to a broker-dealer to purchase an exchange-traded fund (ETF) on a given index where selection of the particular CUSIP was left to the broker-dealer.

divisions, groups, and entities under its control. For purposes of the Rule, affiliate status is determined based on ownership of 25% or more of a class of voting securities.

What Transactions Are Counted Toward the Trigger Levels? Solely for purposes of determining whether the trigger levels are hit, companies may exclude (i) ETF creations and redemptions; (ii) employer option grants; (iii) corporate mergers, acquisitions, self-tenders, buybacks, and certain internal corporate actions (such as journals between accounts of the same entity); (iv) stock lending and equity repurchase agreements; (v) options exercises and assignments; (vi) any transaction that constitutes a gift; (vii) transactions by a executor, administrator, or fiduciary pursuant to distribution of a decedent's estate; (viii) a transaction effected pursuant to a court order; (ix) a transaction pursuant to a rollover of a qualified plan or trust assets; and (x) transactions that are part of an offering of securities by or on behalf of an issuer or by an underwriter on behalf of an issuer so long as the transaction is not effected through an national exchange. The SEC emphasized that these transactions may **not** be excluded by broker-dealers for tracking and reporting purposes.

Registration, Timing, and Voluntary Filing. Once a Large Trader hits the trigger level (either alone or on an aggregated basis), the Large Trader and its control persons must register by filing Form 13H with the SEC within 10 days. Form 13H is a short, simple form that is filed electronically through EDGAR. Persons who do not already have an SEC filing access code must first apply for one by filing Form ID. If the Large Trader is filing on a voluntary basis, it may file Form 13H at any time and thereby reduce the need to actively monitor its trading levels. The Large Trader is not required to identify for the SEC the transactions that caused it to exceed the trigger levels. Form 13H filings are **not** accessible to the public.

Periodic Updates. Large Traders are required to annually file an updated Form 13H after the end of each full calendar year, even if no changes have occurred. Further, if any information in a Large Trader's Form 13H becomes inaccurate for any reason, the Large Trader must file an amended Form 13H no later than the end of the calendar quarter during which the information becomes inaccurate.[5] A Large Trader that has not effected transactions during the prior calendar year may file for inactive status on Form 13H, which becomes effective upon filing. Once on inactive status, a Large Trader may request that its broker-dealers stop maintaining records of its transactions via its identification number.

Self-Identification to Broker-Dealers. Under the Rule, a Large Trader must disclose its identification number to all SEC-registered broker-dealers that effect transactions on its behalf and identify for the broker-dealers each account to which the identifier applies. This disclosure requirement appears to apply not only to broker-dealers that carry the accounts (including prime brokers and clearing brokers) but also to executing brokers, such as floor brokers and $2 brokers.

REQUIREMENTS FOR REGISTERED BROKER-DEALERS

Recordkeeping Requirements. Registered broker-dealers are required to maintain detailed records regarding all transactions in NMS securities effected by or through an account over which a Large Trader has investment discretion, including a proprietary account of the broker-dealer itself. Although the obligations apply to both executing broker-dealers and to prime brokers and clearing brokers, executing broker-dealers are required to carry out the recordkeeping functions only in the event that the

5. In contrast to Form 13H, we note that other SEC Forms, such as certain items in Form ADV, only require updating if information becomes "materially inaccurate." Currently, Form ADV does not require registered investment advisers or exempt reporting advisers to disclose their status as Large Traders.

account for which the information is collected is carried by a bank or other non-broker-dealer. In the event that a transaction is cleared by or given up to another registered broker-dealer, retention of the information is the obligation of the clearing broker or prime broker and not of the executing broker.

Broker-dealers must collect and retain for three years (two of which must be in a readily accessible location) the following information regarding each NMS security purchase and sale by a Large Trader:[6]

- The transaction date and price
- Account number
- Identifying symbol of the security (e.g., CUSIP)
- Number of shares or options contracts traded; whether the transaction was a purchase, sale, or short sale; if it is an option contract, whether the transaction was a call or put, an opening purchase or sale, a closing purchase or sale, or an exercise or assignment
- Clearing house identifier or alpha symbols of the broker-dealer submitting the information and the clearing house identifier or alpha symbols of the entities on the opposite side of the transaction
- Whether the transaction was proprietary or agency
- Name of exchange or market center where transaction was effected
- Execution time
- Large Trader identification numbers associated with the account
- If part or all of the transaction has been transferred or forwarded to accounts of another registered broker-dealer (e.g., a prime broker or clearing broker) or received in by the broker-dealer from another registered broker-dealer (e.g., from an executing broker-dealer or an introducing broker), an identifier regarding the type of transfer
- Identifier assigned by depository institution, if the transaction was processed by a depository

In addition, broker-dealers must retain records regarding all transactions in NMS securities effected by customers that have not registered as Large Traders but that the broker-dealer "knows or has reason to know" should have registered. In the case of these Unidentified Large Traders, the broker-dealer must also retain, with respect to each trade conducted by such a person through the broker-dealer, information regarding the trader's name, address, and tax identification number as well as the date on which the account was opened. Because broker-dealers often do not collect all of this information from the firm or individual having trading authority over a DVP/RVP account or a cash account but instead collect information only regarding the beneficial owner of the account, this recordkeeping requirement may require broker-dealers to collect additional information regarding persons having trading authority over customer accounts.

Reporting to SEC. Upon request from the SEC, the same broker-dealers that are required to collect transaction information regarding Large Traders and Unidentified Large Traders will be required report such trading activity to the SEC. Trading information is required to be reported for a particular day only to the extent that it equals or exceeds the "reporting activity level" of 100 shares.[7] Typically, these reports will be required to be delivered to the SEC at the opening of business on the day following the request. Under particular facts and circumstances, a broker-dealer may be required to report transaction

6. As a result of the recordkeeping requirements of Rule 17a-25, the broker-dealer must also retain average price account identifiers. This requirement was not repeated in the Rule.

7. The Adopting Release does not clarify how the 100-share reporting activity level would apply to option contracts or exchange-traded fixed-income instruments that are NMS securities.

data to the SEC on a Saturday or holiday or even on the day of the SEC's request. The SEC noted that it intends to allow broker-dealers to use the existing infrastructure of the EBS system to fulfill reporting requests, although it has not always been easy for broker-dealers to comply with the existing time line in a timely manner.[8] The SEC may also require broker-dealers to provide them with a list of persons they are treating as Unidentified Large Traders.

Monitoring Customer Transactions for Large Trader Status. The Rule requires broker-dealers to police whether customers should have registered with the SEC as a Large Trader. The monitoring requirements, like the recordkeeping and reporting requirements, apply only to registered broker-dealers that (i) are Large Traders themselves, (ii) carry accounts for Large Traders or Unidentified Large Traders, or (iii) effect transactions on behalf of Large Trader customers whose accounts are carried by non-broker-dealers. As a result, the requirements generally should not apply to brokers-dealers executing on a give-up or introducing basis to another broker-dealer or to ECNs and ATSs. The Rule does not require that broker-dealers affirmatively determine which customers are in fact Large Traders but it does require them to identify potential Large Traders, maintain information about the trading activity of these discretionary managers or traders, and report that information to the SEC upon request.

The Rule also provides a safe harbor for broker-dealers from liability in respect of the monitoring requirements. To rely on the safe harbor, a broker-dealer (i) must not have actual knowledge that a customer should register as a Large Trader, (ii) must comply with the transaction recordkeeping requirements, (iii) must notify Unidentified Large Traders of their potential obligation to register with the SEC, and (iv) must adopt policies and procedures reasonably designed to identify persons who have not complied with the Rule but whose transactions effected through the accounts carried by the broker-dealer or executed by the broker-dealer (considering available account identifying information available to the broker-dealer, such as name and tax identification number) equal or exceed the Large Trader thresholds.

It is unclear to what lengths a broker-dealer must go when setting up its internal system to track and identify Unidentified Large Traders. The suggestion by the SEC in the Adopting Release that a broker-dealer must use "account names, tax identifiers, and other identifying information" about persons having trading authority to identify accounts managed by the same or affiliated persons and then determine whether the Large Trader threshold triggers have been met is a tall task—particularly since the accounts themselves will typically be set up in the name of the beneficial owner and not the trader. The complexity of this requirement is compounded for clearing brokers that carry accounts for hundreds of different introducing brokers, each of whom may have accounts for the same discretionary trader.

It is difficult to imagine that broker-dealers will be able to build out their systems in the nine months allotted in a way that will enable them to carry out the type of monitoring that the SEC appears to contemplate in the Rule. As an initial step, however, and in order to satisfy requirements reasonably designed to identify customers whose transactions at the broker-dealer equal or exceed the identifying activity level, broker-dealers may want to obtain representations regarding Large Trader status from customers as well as information regarding related accounts and the frequency in which customers transact in listed securities across related accounts carried by or executed through the broker-dealer.

ISSUES RAISED BY THE RULE

The Rule imposes a substantial compliance burden on broker-dealers. The timing of the requirements—

8. *See, e.g.,* NYSE Hearing Panel, Southwest Securities, Inc., Decision 05-157 (Jan. 3, 2006).

coming just as financial services firms are gearing up to implement the changes mandated by the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010—is likely to place considerable pressure on compliance and IT personnel and on broker-dealers' budgets. The nine-month compliance deadline for broker-dealers appears to be highly aggressive. That may not be enough time for broker-dealers to build out their systems to accommodate the new transaction information fields to be added to the EBS platform, much less to design and implement a monitoring system to identify Unidentified Large Trader customers.

The Rule also leaves unanswered interpretive questions including (i) whether clearing brokers are required to evaluate accounts carried for different introducing brokers in determining whether an adviser or agent acting across accounts at different introducing brokers is an Unidentified Large Trader; (ii) how the registration and recordkeeping requirements would apply to instruments like security-based swaps and security futures; (iii) how limited exercises of discretion, such as standing orders or Rule 10b5-1 plans, should be treated; and (iv) for Large Traders, how a broker-dealer can distinguish between transactions for which the broker-dealer is required to maintain records (i.e., discretionary transactions) and those for which it is not.

Morgan Lewis will continue to monitor this and other financial industry regulatory developments and is well positioned to help advisers and other traders determine their possible status as a Large Trader and also to assist broker-dealers in drafting and implementing policies and procedures to avail themselves of the safe harbor under the Rule.

If you would like more information or have any questions about any of the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

New York

Georgia Bullitt	212.309.6683	gbullitt@morganlewis.com
Robert C. Mendelson	212.309.6303	rmendelson@morganlewis.com
Joshua R. Blackman	212.309.7131	jblackman@morganlewis.com

Philadelphia

Timothy W. Levin	215.963.5037	tlevin@morganlewis.com
John J. O'Brien	215.963.4969	jobrien@morganlewis.com

Washington, D.C.

Mark D. Fitterman	202.739.5019	mfitterman@morganlewis.com
David A. Sirignano	202.739.5420	dsirignano@morganlewis.com
Steven W. Stone	202.739.5453	sstone@morganlewis.com
Monica L. Parry	202.739.5692	mparry@morganlewis.com