

SEC Proposes Large Trader Reporting System

Introduction

On April 14, 2010, the Securities and Exchange Commission (the “**SEC**”) proposed a new rule to establish a large trader reporting system.¹ The rule would require large traders of exchange-listed stocks and options (“**NMS securities**”) to register with the SEC and obtain a unique large trader identification number, which they would provide to their registered broker-dealers with every order.

The SEC would use the large trader identification numbers to collect information about the orders and transactions of large traders across broker-dealers, analyze their activity and monitor the impact of their trades on the markets. This information would also be used for enforcement purposes and to reconstruct trading activity following periods of unusual market volatility.

Registered broker-dealers would be required to keep records of large traders’ transactions, report this information to the SEC by close of business on the day of a request and monitor for compliance by putative large traders with the registration requirements. The information submitted to the SEC would be confidential and not subject to public reporting.

If adopted, the proposal’s large trader registration and related updating requirements would impose a burden on persons that engage in significant trading in NMS securities to develop and maintain centralized information concerning affiliate and broker-dealer relationships. While the proposal contains provisions that would permit a parent company to assume compliance obligations for controlled affiliates, and vice-versa, we believe that the registration requirements would nonetheless present particular challenges for financial conglomerates that do not currently obtain or manage this information centrally and for companies that do not exert sufficient practical control over affiliates to permit adequate compliance oversight. Because the trigger level for registration is relatively low and has few exceptions, many entities would cross the threshold level unexpectedly (such as by acquiring a block of NMS securities with a value of \$20 million in a single corporate transaction) and then be subject to registration and updating requirements for at least a year.

The broad jurisdictional reach of the registration requirements would ensure that many non-U.S. investors and investment managers would likely be subject to the registration requirements merely because their trades are effected through or their accounts are carried at U.S. broker-dealers. This might well spur the growth of offshore trading of U.S. stocks on organized foreign markets. The expansive jurisdictional reach of the rule would likely also create potential conflicts with foreign laws concerning bank secrecy.

We describe below the key aspects of the SEC proposal and discuss some of the practical and policy considerations it raises.

The Proposal

Proposed Rule 13h-1 under the Securities Exchange Act of 1934 (the “**Exchange Act**”) would apply to large traders who use the U.S. jurisdictional means to effect transactions in NMS securities, subject to a limited set of exceptions, as well as to broker-dealers who effect such traders’ securities transactions.

¹ Exchange Act Release No. 61908 (April 14, 2010).

Large Trader Identification

The core of the proposal is the requirement that any persons who engage in substantial levels of trading activity, “large traders,” register with the SEC by filing Form 13H with the SEC and updating it at least annually and quarterly if necessary. A large trader is defined under the proposal as a person who:

- “directly or indirectly, including through other persons controlled by such person, exercises investment discretion² over one or more accounts, *and*
- effects transactions for the purchase or sale of NMS securities 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.”

The identifying activity level is:

- two million shares or shares with a fair market value of \$20 million in a single day; *or*
- twenty million shares or shares with a fair market value of \$200 million in a single month.³

The value of purchases and sales of stocks and options would be aggregated without netting or offsetting these purchases and sales.

The rule attempts to reduce the number of registrations by requiring that only control persons of large traders need register, even if one or more persons they control cross the identifying activity level. A control person is a large trader if the aggregate of the trades of their controlled persons exceeds the identifying activity level. Alternatively, if each controlled person that is a large trader registers individually, the control person need not itself register unless it is separately a large trader.⁴

The proposal includes seven narrow exclusions from the definition of “transaction” that removes specific limited activities from the identifying activity level and from the reporting requirements for large traders. These limited activities are:

- bookkeeping entries memorializing the settlement of transactions;
- offerings by or on behalf of an issuer;
- gifts;
- distributions of estates;
- transactions ordered by a court;

² “A person exercises ‘investment discretion’ with respect to an account if, directly or indirectly, such person (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 even though some other person may have responsibility for such investment decisions, 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 Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this chapter and the rules and regulations thereunder.” 15 U.S.C. § 78c(a)(35).

³ Listed options, as NMS securities, would be covered by the rule. Over-the-counter options would be outside the scope of the rule, though purchases or sales of NMS securities upon exercise probably would be covered. Separately, the SEC staff is developing, for SEC consideration, a proposal to establish a consolidated audit trail for equities and options that would collect and consolidate detailed information about orders entered and trades executed on any exchange or in the over-the-counter market.

⁴ The rule 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.” The rule would presume control where a person directly or indirectly has the right to vote or direct the vote of, or has the power to sell or direct the sale of, 25 percent or more of a class of voting securities of an entity. For a partnership, the threshold would be the contribution of, or right to receive upon dissolution, 25 percent or more of the capital. The rule does not indicate how, if at all, the “presumption of control” may be rebutted.

- rollovers of a retirement plan; and
- transactions pursuant to an issuer benefit plan.

The rule also provides exemptive authority, which would probably be delegated to SEC staff.

Large Trader Obligations

A large trader would be required to register “promptly”⁵ after the aggregate daily or monthly trading volumes of the trader and its controlled persons equal or exceed the identifying activity threshold. To register, a large trader must file Form 13H with the SEC, and thereafter must update its Form 13H at least annually, and on a quarterly basis if necessary to correct information that becomes inaccurate. The large trader must also promptly provide, on request, additional descriptive or clarifying information that would allow the SEC to further identify the large trader and all accounts through which the large trader effects transactions.

Upon receipt of the Form 13H, the SEC would issue the large trader a unique Large Trader Identification Number (“**LTID**”). The LTID would be used for all accounts over which the large trader directly or indirectly controls or exercises investment discretion, across broker-dealers, thereby providing the SEC with a full picture of each large trader’s activity in NMS securities.

Each large trader would also be required to disclose its LTID to registered broker-dealers effecting transactions on its behalf, identify each account to which it applies and provide its LTID to all persons with whom the large trader collectively exercises investment discretion.

As a means designed to prevent evasion of the self-identification and other large trader requirements, the rule would prohibit a person from disaggregating accounts and splitting activity among multiple broker-dealers or transactions. Moreover, a person would not be able to avoid registering as a large trader by exercising coordinated and joint investment discretion over individual accounts with another party because each person or entity exercising such discretion would be required to count the transactions in NMS securities through those accounts toward its own identifying activity level.

Traders whom broker-dealers believe to be large traders but who do not register with the SEC would be deemed Unidentified Large Traders.

The rule allows a large trader to file for inactive or terminated status if it did not reach the identifying activity level for a full calendar year or has ceased operations.

Form 13H requires the following information, among other things, to be disclosed:

- the business of the large trader;
- whether any of the large trader’s affiliates files forms with the SEC;
- whether the large trader or any of its affiliates is a registered trader or otherwise registered with the CFTC, bank holding company, bank, foreign bank, insurance company or is regulated by a foreign regulator.
- whether the large trader exercises investment discretion as a trustee, partnership, or corporation;
- if a natural person, whether the large trader is self-employed or otherwise employed;
- the name of each general or limited partner that is the owner of more than a 10 percent financial interest in the accounts of the large trader;

⁵ The SEC has requested comment as to whether “promptly” should be defined as a strict ten-day limit.

- the executive officers, directors, or trustees of the large trader corporation or trustee;
- the jurisdiction in which the large trader is organized and its principal place of business;
- the nature of the large trader entity's business; and
- for all accounts over which the large trader directly or indirectly exercises investment discretion:
 - the name of the broker-dealer that holds the account;
 - the account number;
 - the account name; and
 - if applicable, the LTID of any other large traders that exercise investment discretion over the identified accounts.

Broker-Dealer Responsibilities

The proposal would place broad recordkeeping, reporting and monitoring responsibilities on broker-dealers with respect to large traders who maintain accounts with them.

Recordkeeping

A broker-dealer would be required to record the LTID for every qualifying transaction for a large trader or Unidentified Large Trader, and retain the record for three years. Broker-dealers would continue to record the information they currently collect through Electronic Blue Sheets (“EBS”), and also the time of the transaction, which is not currently required by EBS.⁶ For Unidentified Large Traders, broker-dealers also would be required to record the Unidentified Large Trader's name, address, tax identification number(s) and the date on which the trader's account was opened. If a broker-dealer is itself a large trader, it must record the required information with respect to each account over which it exercises investment discretion.

Reporting

If requested by the SEC, a broker-dealer would have to provide the required information with respect to each transaction by a large trader or an Unidentified Large Trader in NMS securities of 100 shares or more. Broker-dealers must have the information available the day after the trade, and would have to comply with any request for large trader information by the close of business on the day on which the request is made.

Monitoring

Broker-dealers would have a significant role in monitoring for compliance by large traders with the registration and reporting requirements. A broker-dealer would have to treat a person as an Unidentified Large Trader if that person effects transactions in NMS securities through the broker-dealer that exceed the identifying activity level.

However, the proposal creates a “safe harbor” from this requirement for broker-dealers who have no actual knowledge that a trader is a large trader and who adopt reasonable policies and procedures for monitoring client accounts but fail to identify Unidentified Large Traders. Such policies and procedures should detect and identify large traders' accounts based on account name, tax identification number, and other readily available information, such as written authorizations or orders from a single person that relate to multiple accounts. When a broker-dealer's safe harbor policies and procedures detect an

⁶ The information currently required to be supplied on the EBS includes, among other items: date the transaction was executed; account number; identifying symbol assigned to the security; transaction price; number of shares or option contracts traded in each specific transaction designation of whether the transactions was proprietary or for a customer; the identity of the execution market; and a prime broker identifier.

Unidentified Large Trader, the broker-dealer must inform that trader of its obligation to register as a large trader with the SEC.

Confidentiality

The information provided to the SEC by large traders and broker-dealers under the proposal would be required to be treated confidentially and would be exempt from disclosure under the Freedom of Information Act.

Foreign Entities

Any person, including a foreign entity, that uses the U.S. jurisdictional means to effect transactions in NMS securities through registered broker-dealers and exceeds the identifying activity level must register as a large trader.⁷ Only registered broker-dealers are subject to the rule's recordkeeping and reporting requirements.

Implementation

The large trader identification requirements would become effective three months after adoption of a final rule, while the broker-dealer recordkeeping and reporting requirements would become effective after six months. These accelerated time schedules are based on the SEC's determination that the EBS system provides the infrastructure to allow for an efficient transition.

Commentary

Pervasive Registration Requirements – Welcome to the SEC!

Given the rule's low identifying activity level, many hundreds, even thousands of U.S. and foreign market participants who have had no prior SEC contact would be required to register and provide identifying information to the SEC. Unexpected entities, like corporate parents of capital market participants, would be required to register unless they diligently ensure that all large traders under their control have registered. Most corporate acquirers of exchange-listed issuers would become large traders. Individual high-frequency traders and hedge fund managers who are exempt from registration as investment advisers could be required to register. For the first time, such persons and entities would be identified to the SEC and their trading could be easily monitored by the SEC and presumably the self-regulatory organizations.

Foreign Traders

Foreign traders that effect transactions in NMS securities through a bank or foreign broker-dealer may be subject to the rule if at some stage the transactions are effected through a registered broker-dealer.⁸ Moreover, a registered broker-dealer that carries the account of a bank or foreign broker-dealer would be required to obtain the identity of Unidentified Large Traders using that account. The consequences of

⁷ The rule would apply to all transactions in NMS securities effected through registered broker-dealers, including those that involve trades in foreign over-the-counter markets or exchanges. Persons otherwise using any "means or instrumentality of interstate commerce or of the mails, or any facility of a national securities exchange" (the "U.S. jurisdictional means") to trade NMS securities on a foreign exchange, to the extent their trades reach the identifying activity level, would be required to register as large traders. Trades in NMS securities in foreign markets that are effected without the participation, direct or indirect, of registered broker-dealers or other use of the U.S. jurisdictional means would be outside the rule.

⁸ While the statutory provision under which the rule is proposed excludes foreign central banks from the scope of "persons" who may be large traders subject to the rule, other governmental entities, including sovereign wealth funds, who trade or manage portfolios of NMS stocks with discretionary authority are not excluded.

failing to obtain this information are unclear; notably, the proposal asks about the appropriate response to foreign statutes that could block provision of customer information.

Limitations in Scope

Registration as a large trader is triggered only by transactions in NMS securities. To avoid registering and reporting large trader transactions, active traders may choose to gain equity exposure by trading in other instruments that are not NMS securities, including futures on securities indices, single stock futures, and equity derivatives. Foreign traders may choose to avoid U.S. markets and trade U.S. securities on overseas markets, such as NYSE Arca Europe and Turquoise, a multilateral trading facility majority-owned by the London Stock Exchange.

Recordkeeping and Monitoring

There are practical challenges for broker-dealers in satisfying their recordkeeping and monitoring duties. In particular, broker-dealers would need to develop monitoring and compliance systems for identifying persons seeking to evade identification as large traders by disaggregating and coordinating their trades across accounts, where each account does not reach the threshold reporting level. Presumably, a broker-dealer would need to monitor accounts with trades that equal or exceed the threshold level as well as trades below that level. Although the SEC's explanation of the Rule asserts that it is tailored to minimize the burden on broker-dealers, developing and implementing such monitoring and compliance systems may in practice prove difficult and expensive.

In addition, while the rule would build on the existing EBS system infrastructure, broker-dealers would need to set up processes for tracking and reporting through the EBS system LTIDs and the time of trades.

The rule would require broker-dealers to provide transactional data to the SEC the day after a request for such data is made by the SEC. By contrast, the existing EBS reporting system does not require that broker-dealers provide information to the SEC by a definitive date. The SEC asserts that the current reporting system is often subject to lengthy delays and that the staff often must make multiple requests to receive the relevant trading data. Transitioning from the EBS reporting system to the proposal's next-day reporting regime may pose significant logistical difficulties if broker-dealers have to overhaul their existing data-collection systems to comply with the accelerated reporting requirement.

Entity Reporting

Complex entities would need to decide how best to structure their large trader reporting identification, that is to say, to register the parent entity or to have each large trader register individually. In the latter case, the parent entity would need to ensure compliance by all of its controlled entities and employee large traders to satisfy itself that it does not also have to register. At the same time, the requirement that a parent entity report itself as a large trader if it meets the identifying activity level on an aggregate basis, even where no single controlled affiliate meets the level, undercuts the flexibility of the rule that would otherwise allow for individual reporting by controlled entities and could make compliance more costly.

In registering itself, a large trader would need to disclose on Form 13H information about its business, the accounts over which it exercises investment discretion, the persons with whom it exercises joint investment discretion, its regulated affiliates, its ownership structure (including, in the case of a partnership, the names of each general partner or 10 percent limited partner), and the executive officers, directors and trustees of a large trader corporation or trustee. The requirement that a large trader identify all other large traders with whom it shares investment discretion over an account could be problematic for a number of investors where such information is sensitive or otherwise has remained private. There likely would be difficult questions around the meaning of the term "investment discretion" and whether there exists joint or shared investment discretion, given the definition of this term under the rule.

The ownership disclosure requirements, in particular, pose challenges. Some investors may be uncomfortable disclosing information about ownership. In addition, because control is presumed for any ownership level at or above 25 percent, there may be practical problems for joint ventures and minority-owned entities that may not have the right to obtain information with respect to all of their affiliates (as defined).

Large foreign banks may face heightened practical challenges in completing Form 13H because they may not have centralized records for all of their large trader affiliates, which may number in the hundreds. The three-month compliance period following adoption of the rule may not be enough time for such entities to gather the information required to be filed with the SEC (particularly in light of the requirement to file “promptly”). The rule proposal lacks a grace period for dealing with such practical difficulties.

The updating requirement would pose significant issues for complex entities. The rule would seem to require that every time an affiliate sets up a new account to manage or establishes a new broker-dealer relationship, an amendment would have to be filed. A parent entity that has assumed the large trader reporting obligations for its controlled affiliates would need to develop and implement an entirely new tracking system for such changes.

Request for Comment

The release requests comments on a range of issues including the identifying level of activity, the definition of investment discretion and transaction, whether certain categories of persons should be exempt, whether broker-dealers should be required to report transaction data on a weekly or periodic basis to the SEC, the incentives for traders to transfer their business to foreign broker-dealers exempt from registration and the treatment of foreign entities. The comment period will last for 60 days following publication of the rule in the Federal Register, which is likely to occur imminently.

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