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New Rule 13h-1: The SEC Adopts a Large Trader Reporting System

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On July 27, 2011, the Securities and Exchange Commission (''SEC'' or ''Commission'') adopted Rule 13h-1 and Form 13H under the Securities Exchange Act of 1934 (''Exchange Act''), which requires persons who are deemed to be large traders to register with, and to provide certain information about themselves and their affiliates to, the Commission.[1]

I. Obligations of Large Traders

A. Introduction

If a person meets the definition of ''large trader,'' it (or he or she, as discussed below) is required to register with the SEC on Form 13H, to provide certain information about itself and its affiliates, and to obtain a larger trader ID (''LTID''). Because a single transaction of sufficient size or value can cause a person to be deemed a large trader, the SEC signaled its intent not to limit the reporting requirement to active traders. Nevertheless, as discussed below, many routine corporate transactions are not counted in determining if a person is a large trader (*e.g.*, share repurchases, stock lending, employee compensation plans involving stock awards and option grants, business combinations, and offerings off an exchange). Large traders must file their first Form 13Hs with the SEC by December 1, 2011.

B. Large Trader Definition

Rule 13h-1(a)(1)(i) defines ''large trader'' as any person that ''[d]irectly 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 who voluntarily registers with the SEC by filing Form 13H is also a ''large trader.''

1. Definition of ''Person''

A ''person'' is defined as ''a natural person, company, government, or political subdivision, agency, or instrumentality of a government,'' and also includes ''two or more persons acting as a partnership, limited partnership, syndicate, or other group, but does not include a foreign central bank.''[2] Contrary to Form 13F, natural persons are not exempt from filing Form 13H. Foreign entities can also be large traders.

2. Definition of ''Control''

''Control'' (which includes ''controlling,'' ''controlled by'' and ''under common control with'') is defined in Rule 13h-1(a) 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.'' Control is presumed to exist if a person, directly or in-

[1] Release No. 34-64976 (July 27, 2011).

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[2] This is the definition of ''person'' set form in Section 3(a)(9) of the Exchange Act.

directly, has the right to vote, or the power to sell or to direct the sale of 25% of more of a class of voting securities of an entity, or, in the case of a partnership, the right to receive, upon dissolution, or has contributed, 25% or more of the capital of an entity.

3. Definition of ''Investment Discretion''

For purposes of Form 13H, the SEC used the definition of ''investment discretion'' in Section 3(a)(35) of the Exchange Act:

> 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 title and rules and regulations thereunder.[3]

Employees who exercise investment discretion within the scope of their employment are deemed to exercise investment discretion on behalf of their employer.

C. Parents and Subsidiaries

A large trader can comply with Rule 13h-1 by either the ultimate control person registering and filing Form 13H on a consolidated basis for all accounts that it controls; or one or more persons controlled by the large trader collectively complying with respect to all of the large trader's accounts.[4] If affiliates comply separately, each entity under common control must identify the ultimate parent as well as any other affiliate on its Form 13H.

D. Identifying Activity Levels

Form 13H must be filed if a person effected transactions in ''NMS securities'' by or through one or more registered broker-dealers that, in aggregate, equaled or exceeded the ''identifying activity level.'' An ''NMS security'' is defined in Rule 600(b)(46) of 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.'' Generally, NMS securities include all equity securities and options listed on a national securities exchange.

The ''identifying activity level'' is (1) 2 million shares or $20 million during any calendar day, or (2) 20 million shares or $200 million during any calendar month. The following transactions should be excluded when determining if the identifying activity level is met:

1. transactions pursuant to options exercises or assignments;
2. employer option grants and stock awards;
3. creations and redemptions of exchange traded funds (''ETFs'');[5]
4. transactions to effect a business combination, self-tenders, other buybacks or equity repurchase agreements, and stock loan agreements;
5. 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 the facilities of a national securities exchange;
6. gifts;
7. transactions by an executor, administrator, or fiduciary pursuant to distribution of a decedent's estate;
8. transactions effected pursuant to a court order; and
9. transactions pursuant to the rollover of a qualified plan or trust assets.

The calculation of the identifying activity level must be on a gross basis across all controlled entities, and cannot be offset (*e.g.*, by hedging transactions). Affiliate's trading activity must be included even if there are effective information barriers for purposes of Regulation M or other regulatory requirements. The volume or fair market value of the underlying equity securities is used to calculate the activity level of options.

II. Form 13H

A. Initial Filing and Receipt of Large Trader Identification Number

Form 13H must be filed with the SEC via EDGAR ''promptly'' after a large trader reaches the identifying activity level. Under ''normal'' circumstances, which the Commission did not define, the SEC will view initial registrations filed within 10 days after a large trader reaches the identifying activity level to be filed promptly.

B. Quarterly Amended Filings and Annual Updates

If information contained in Form 13H becomes inaccurate, the large trader must file an amended Form 13H promptly following the end of any calendar quarter during which the information became inaccurate. Even if no changes have occurred, large traders must file a current Form 13H within 45 days after the end of each full calendar year.

C. Inactive Status

If a reporting large trader subsequently passes a full calendar year without effecting aggregate transactions in an amount equal to or greater than the identifying activity level, it may become inactive by filing a Form 13H

[3] 15 U.S.C. § 78c(3)(a)(35).

[4] In certain scenarios, it may make sense for certain affiliates of a large trader to register and report separately as large traders, but the large trader likely would want to implement compliance controls and checks to allow it to rely on the portfolio company's use of its own LTID.

[5] While this exemption excludes the transfer of such securities between an authorized participant and an ETF, it does not exempt secondary market transactions related to the acquisition or disposition of securities in connection with the creation or redemption of ETF shares.

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and will no longer be required to file Form 13H or identify its large trader status unless its transactions again reach the identifying activity level. Some large traders may find it more convenient to continue filing if they expect that they will regain large trader status in the near future, rather than repeatedly registering and deregistering

D. Termination Filings

A large trader that terminates operations and has no chance of requalifying for large trader status in the future may permanently end its large trader status by amending its Form 13H to indicate its terminated status.

III. Information That Must Be Reported

Generally, six items of information must be provided on Form 13H:

A. **Large Trader's Businesses.** Item 1 requires the large trader to check all boxes identifying the types of business in which it is engaged. A large trader also must select ''other'' to indicate a financial entity not included in any of the listed categories and to enter a short description for each such entity. A large trader who is an individual must check ''other'' and input his or her occupation. A large trader also is required, for itself and each of its affiliates that exercise investment discretion over NMS securities (''Securities Affiliates''), to explain the nature of its operations, including a general description of its trading strategies.

B. **SEC Filings.** Item 2 requires a large trader to indicate whether it or any of its Securities Affiliates files forms with the Commission. If the large trader checks ''Yes,'' it must input the names of the filing entities, the form(s) they file, and the applicable CIK number.

C. **Commodity Futures Trading Commission Registration and Foreign Regulators.** Item 3(a) requires the large trader to indicate whether it or any of its affiliates, not just Securities Affiliates, is registered with the Commodity Futures Trading Commission (''CFTC'') in any capacity, including as a ''registered trader.'' If it checks ''Yes,'' the large trader must input the name and registration number of each such entity. Item 3(b) requires the large trader to indicate whether it or any of its Securities Affiliates, but not all affiliates, is regulated by a foreign regulator. If the large trader checks ''Yes,'' it must provide the name of each such regulated entity and its primary foreign regulator.

D. **Organization Information.** Item 4(a) requires the large trader to attach an organizational chart showing the organization of the large trader. At a minimum, the chart must include the large trader, its parent company (if applicable), all Securities Affiliates, and all affiliates registered with the CFTC (collectively, ''Item 4 Affiliates'').

   Item 4(b) requires that a large trader provide the names of its Item 4 Affiliates and, for each one of them, also submit: all market participant identifiers, if any (''MPIDs''), a brief description of its business, and its relationship to the large trader.

   Item 4(c) requires that a large trader identify all affiliates that separately file Form 13H under a different LTID.

   Item 4(d) permits a large trader to assign LTID suffixes to sub-identify persons, affiliates, departments, or units that directly control an account. A suffix should have no more than three characters, all of which must be numbers. The same suffix may not be assigned to more than one affiliate using the same LTID.[6]

E. **Governance of the Large Trader.** Item 5 requests basic information about the large trader organization (*i.e.*, it is an individual, trustee, limited liability company, partnership, limited partnership, or corporation). If a foreign organization type has no comparable corporate form, it must check ''Other'' and input the organization type.

F. **Broker-Dealers at Which the Large Trader or Its Securities Affiliates Has an Account.** Item 6 requires a large trader to identify each prime broker, executing broker and clearing broker at which the large trader and any of its Securities Affiliates has an account, and to check the relevant account type.

IV. Self-Identification to Broker-Dealers

A large trader must disclose to broker-dealers effecting transactions in NMS securities on its behalf the LTID and each account to which it applies. If a large trader on inactive status resumes large trader status, it must notify broker-dealers promptly after reactivating its status with the SEC.

V. Obligations of Broker-Dealers

A. Large Trading Reporting on Form 13H

Broker-dealers may themselves be large traders and required to file Form 13H if transactions in their proprietary accounts and other accounts over which they exercise investment discretion meet the identifying activity level.

B. Recordkeeping Requirements

SEC-registered broker-dealers (but not broker-dealers that are not registered with the SEC) are required to maintain certain information with respect to all transactions effected for a large trader or any person that does not comply with Rule 13h-1's self-identification requirement and that a registered broker-dealer knows or has reason to know is a large trader (an ''Unidentified Large Trader'').

The information required to be maintained includes transaction information, account number(s), clearing house information and the large trader's LTID. This requirement applies to all transactions effected directly or indirectly by or through (1) an account that the broker-dealer carries for a large trader or an Unidentified Large Trader, (2) any proprietary or other account over which the broker-dealer exercises investment discretion, if the broker-dealer is itself a large trader, or (3)

[6] The SEC encouraged large traders to assign suffixes by saying that they may decrease the need to contact a large trader for assistance in further identifying its accounts.

the broker-dealer itself that are carried by a non-broker-dealer.

Broker-dealers are not required to maintain records of transactions by an inactive large trader after receiving notice from the large trader that the trader had filed for inactive status with the Commission on Form 13H.

Records and information that SEC-registered broker-dealers are required to retain under Rule 13h-1 must be maintained in accordance with Exchange Act Rule 17a-4 for a period of three years, the first two years in an accessible place.

C. Reporting Requirements

Upon the request of the Commission, every broker-dealer that is registered with the SEC and who is itself a large trader or carries an account for a large trader or an Unidentified Large Trader is required to report electronically to the SEC all information that it is required to maintain pursuant to Rule 13h-1(d) for all transactions effected directly or indirectly by or through accounts carried by the broker-dealer for large traders and Unidentified Large Traders that are equal to or greater than the reporting activity level.

If a non-broker-dealer, *e.g.*, a bank, carries an account for a large trader or an Unidentified Large Trader, the broker-dealer effecting such transactions, directly or indirectly, for the large trader must report such information electronically.

D. Monitoring Requirement and Safe Harbor

Rule 13h-1 requires that SEC-registered broker-dealers treat as an Unidentified Large Trader (for purposes of the recordkeeping and reporting requirements) any person that the broker-dealer ''knows or has reason to know'' is a large trader if such person has not identified itself as a large trader to the broker-dealer and disclosed the accounts to which its LTID applies.

The SEC included a safe harbor in paragraph (f) of Rule 13h-1, which provides that a registered broker-dealer is deemed not to know or have reason to know that a person is a large trader if it does not have actual knowledge that a person is a large trader and it establishes policies and procedures reasonably designed to identify customers whose transactions at the broker-dealer equal or exceed the identifying activity level. The broker-dealer's policies and procedures must provide that any Unidentified Large Traders will be treated as such and that the broker-dealer will notify such persons of their potential reporting obligations under this Rule

VI. Timing

Although the first Form 13H is not due to the Commission until December 1, 2011, two of the metrics in determining whether a person is a large trader are based on one calendar month's trading. Accordingly, in advance of this deadline, persons who may be deemed ''large traders'' should map their organizational structure, and determine if they will be subject to Rule 13h-1 based on the aggregate amount of transactions in NMS securities.

Broker-dealers will need to build the operational and compliance systems needed to start maintaining records and complying with their monitoring and reporting obligations by April 30, 2012. The firms' written supervisory procedures will also need to be updated to reflect these new obligations.

VII. Confidentiality

The SEC stated that it will treat as confidential the information collected on Form 13H and pursuant to Rule 13h-1, unless the Commission receives a request to provide the information to Congress or to another Federal department or agency, or an order of a U.S. court in an action brought by the United States or the Commission. Section 13(h)(7) specifies that the information is protected under the Freedom of Information Act.[7]

[7] 5 U.S.C. § 552.

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