

US Securities and Exchange Commission Adopts Large-Trader Reporting System

On July 26, 2011, the US Securities and Exchange Commission (SEC) voted unanimously to adopt Form 13H and Rule 13h-1 under the Securities Exchange Act of 1934 (Exchange Act). The formal adopting release was issued on July 27.¹ Although Rule 13h-1 is technically effective on October 3, 2011, the Adopting Release provides two staggered compliance dates for the rule's key provisions.

First, as of December 1, 2011, Rule 13h-1(b) will require all persons whose daily or monthly trading volume exceeds certain thresholds described below in "NMS securities" (i.e., generally any equity security or option listed on a US national securities exchange)² to register with the SEC as "large traders" on Form 13H and disclose their SEC-assigned large trader identification number (LTID) thereafter to the SEC-registered broker-dealers effecting transactions on their behalf. Second, as of April 30, 2012, paragraphs (d), (e) and (f) will impose certain recordkeeping and reporting requirements on SEC-registered broker-dealers.

Background

Rule 13h-1 was adopted under Exchange Act Section 13(h), which authorizes the SEC to establish a large trader reporting system. This section was added to the Exchange Act by the Market Reform Act of 1990, because the US Congress perceived the SEC as lacking sufficient trading information to analyze significant declines in the US securities markets in

October 1987 and October 1989. The SEC has previously proposed, but not adopted, rules under Section 13(h) on two separate occasions.³ Accordingly, some observers were skeptical that the SEC would adopt this iteration of a large trader reporting system when it was proposed in April of 2010.⁴

The Proposing Release was issued in part to account for weaknesses identified by an equity market structure concept release published in February of 2010.⁵ In particular, the SEC expressed concern in the concept release that the increased automation and speed of trading had outpaced the SEC's ability to effectively monitor the US securities markets. The SEC's difficulty in analyzing the events of May 6, 2010 (i.e., the sudden and precipitous drop in US securities markets known as the "flash crash") served to underscore this concern.⁶

Although the SEC received a wide range of comments from 87 different commenters on the Proposing Release, the SEC has adopted the rule largely as proposed (with a few key differences noted below).

Large Trader Provisions (Compliance Date of December 1, 2011)

DEFINITION OF LARGE TRADER

Rule 13h-1(a)(1) defines a "large trader" to be any person that, directly or indirectly, including through other persons controlled by such person,⁷ exercises investment discretion⁸ over

one or more accounts and effects transactions⁹ for the purchase or sale of any NMS security for, or on behalf of, such accounts in amounts equal to or exceeding “identifying activity levels.” Note that large traders are not limited to “US persons,” as such term is defined in the SEC’s Regulation S, nor does the rule itself contain any express jurisdictional limitations even though Exchange Act Section 13(h)(8)(A) does. Specifically, the statute (but not the rule) requires the “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....” Presumably, the SEC will respect the statutory limit and apply the rule to non-US large traders only to the extent that they use US jurisdictional means (including any facility of a US national securities exchange).¹⁰

Rule 13h-1(a)(7) defines “identifying activity level” to be aggregate transactions in NMS securities equal to or greater than “two million shares or shares with a fair market value of \$20 million” in a single calendar day, or “twenty million shares or shares with a fair market value of \$200 million” during a calendar month. Given these activity levels, the SEC estimates that roughly 400 entities will meet the definition of large trader.¹¹

LARGE TRADER IDENTIFICATION OBLIGATIONS

Under Rule 13h-1(b)(1), large traders must register with the SEC using new Form 13H. Upon receipt of this form, the SEC will provide the person with an LTID. Under Rule 13h-1(b)(2), each registered large trader must provide its LTID to the SEC-registered broker-dealers effecting transactions on the large trader’s behalf.

A large trader must file Form 13H “promptly” after its activities require registration. While the rule does not define “promptly,” the SEC stated that it expects registration within 10 days.¹² Additionally, the large trader must file an updated Form 13H within 45 days of the end of

each full calendar year, and a large trader must also file a revised Form 13H “promptly” following the end of any calendar quarter in which a prior filing becomes inaccurate. The form collects identifying information about a large trader, including:

- The businesses engaged in by the large trader and its affiliates;
- Whether the large trader or its affiliates files any other forms with the SEC;
- Whether the large trader or its affiliates have registered with the CFTC or non-US regulators;
- An organizational chart encompassing all affiliates, parents and subsidiaries;
- Governance information about the large trader, including the type of business entity and ownership information; and
- The broker-dealers (not limited to SEC-registered, so this includes non-US broker-dealers) at which it, or its affiliates, maintains an account.

The Proposing Release would have required the disclosure of account numbers for each broker-dealer at which a large trader maintained an account. Comment letters persuaded the SEC to require Form 13H filers to provide only the names of broker-dealers.¹³ The SEC, however, reserves the right to request account numbers from the large trader’s broker-dealers.

Several commenters on the Proposing Release expressed concerns regarding the confidentiality of Form 13H filings. In response, the SEC noted that Exchange Act Section 13(h)(7) requires the SEC to keep this information confidential, except to grant access to other federal agencies or to comply with orders of US courts.¹⁴ Specifically, Form 13H filings are exempt from Freedom of Information Act requests.

Under Rule 13h-1(b)(3)(i), a large trader does not need to register if a controlling person (e.g., a parent of a large trader subsidiary) separately complies with the rule on behalf of the large

trader.¹⁵ Similarly, under Rule 13h-1(b)(3)(ii), a parent does not need to register if all large traders under its control individually comply with the identification requirements.

SEC-Registered Broker-Dealer Provisions (Compliance Date of April 30, 2012)

Rule 13h-1 imposes a number of recordkeeping and reporting obligations on SEC-registered broker-dealers. These obligations are not imposed on other financial intermediaries who are not registered with the SEC as broker-dealers—e.g., US banks, non-US banks and non-US broker-dealers—although such financial intermediaries may of course be large traders subject to the provisions of the rule discussed above.

RECORDKEEPING

Apart from identifying themselves as large traders where applicable,¹⁶ SEC-registered broker-dealers must maintain certain records in connection with accounts carried for large traders or “unidentified large traders,” which term is defined in Rule 13h-1(a)(9) to include any person that an SEC-registered broker-dealer knows or has reason to know (i) is a large trader (i.e., has effected transactions in NMS securities with or through accounts with the SEC-registered broker-dealer in excess of the identifying activity levels) and (ii) has not complied with the large trader identification requirements. For transactions effected by or through the foregoing accounts, Rule 13h-1(d)(2) requires SEC-registered broker-dealers to keep a variety of data elements, including:

- The identifying symbol assigned to each security in a transaction;
- The date, time and price of execution;
- The number of shares or contracts traded in each transaction;
- The exchange or market center where the transaction was executed;
- Whether the transaction was a purchase, sale, or short sale, and with respect to an option contract, whether the transaction was a put or call option, an opening or closing purchase or sale, or an exercise or assignment;
- Whether the broker acted as agent or principal; and
- The LTID associated with the account, unless the account is for an unidentified large trader.

The rule does not require SEC-registered broker-dealers to close accounts of unidentified large traders; rather, SEC-registered broker-dealers effectively are required under Rule 13h-1(f) to inform apparent large traders of their potential identification obligations under the rule. If an SEC-registered broker-dealer effects a transaction for an account of an unidentified large trader, a record must be kept of the name, address, account-opening date and any tax identification numbers for the account under Rule 13h-1(d)(3).

REPORTING

Under Rule 13h-1(e), upon request by the SEC, SEC-registered broker-dealers must electronically report the information kept in the records noted above using the infrastructure supporting Exchange Act Rule 17a-25—i.e., the Electronic Blue Sheet system. These reports must be available to the SEC on the morning after the day of each large trader transaction, including Saturdays and holidays. In unusual circumstances, the SEC may request the same-day availability of records.¹⁷

Practical Issues

As adopted, the rule and form raise a number of practical issues. We highlight below a few of these issues.

THE ROLE OF INTERMEDIARIES THAT ARE NOT SEC-REGISTERED BROKER-DEALERS

As noted above, many of the key provisions of the rule apply only to SEC-registered broker-dealers. Given the widespread use of financial

intermediaries that are not registered with the SEC as broker-dealers—e.g., US banks, non-US banks and non-US broker-dealers (collectively, “Non-SEC Intermediaries”), the utility of the rule is somewhat questionable.

For example, assume a putative large trader uses a Non-SEC Intermediary for custody and self-directed brokerage services (i.e., the Non-SEC Intermediary does not exercise investment discretion). If this putative large trader directs the Non-SEC Intermediary to buy more than 2 million shares of NMS securities on a particular trading day, and the Non-SEC Intermediary sends one or more orders to an SEC-registered broker-dealer for execution (for an account in the name of the Non-SEC Intermediary held with the SEC-registered broker-dealer), the SEC-registered broker-dealer will execute the order(s) and inform the Non-SEC Intermediary that the Non-SEC Intermediary appears, from the perspective of the SEC-registered broker-dealer, to be a large trader. If the Non-SEC Intermediary does not give the SEC-registered broker-dealer an LTID, the SEC-registered broker-dealer will keep records listing the Non-SEC Intermediary as an unidentified large trader.

In this example, the Non-SEC Intermediary is not itself a large trader because it does not exercise investment discretion (assuming there is no other *proprietary* or *discretionary client* large trading by the Non-SEC Intermediary). The Non-SEC Intermediary is not required to inform its putative large trader client that the client is a large trader because the rule only imposes this notification requirement on SEC-registered broker-dealers.

Assuming for the sake of argument that the Non-SEC Intermediary informs the putative large trader client (or that putative large trader client is independently aware of the new rule, which seems especially unlikely in the case of non-US large traders with no prior experience with the SEC), the putative large trader client will file a Form 13H. If this large trader client files, the form appears to require disclosure of the

Non-SEC Intermediary because the SEC states that disclosure of a “foreign intermediary” is required by “foreign large traders.”¹⁸ This raises the question of how this newly registered large trader will disclose its LTID to “the registered broker-dealers effecting transactions on its behalf”? In our example, the large trader may not know which, if any, SEC-registered broker-dealers the Non-SEC Intermediary uses.

There is no obligation for this newly registered large trader to share its new LTID with the Non-SEC Intermediary, nor is there a mechanism for this newly registered large trader to share its LTID with unknown and perhaps unknowable, from the trader’s perspective, executing SEC-registered broker-dealers. Thus, there is no clear benefit to the SEC in requiring this large trader to register because the executing SEC-registered broker-dealers will continue to show the Non-SEC Intermediary as an unidentified large trader.

INCENTIVE TO MOVE AWAY FROM NMS SECURITIES

As noted by commenters on the Proposing Release, the rule may incentivize large traders to shift from trading in NMS securities to engaging in transactions that provide an economically equivalent long position but would not impose any reporting requirement.¹⁹ For example, many NMS stocks are available in the form of European Depositary Receipts or Global Depositary Receipts available on an over-the-counter basis or through listing on European stock exchanges, and many European exchange-traded funds also contain NMS security underliers. Alternatively, economic exposure to NMS securities could be obtained through derivatives, such as single-stock futures or single-stock total return swaps.

The SEC is fairly dismissive of these concerns. Rather than acknowledging that there may be lower-cost alternatives to transactions in NMS securities, the SEC suggests that the commenter failed to provide data to support the concern

raised by the commenters. Oddly, the SEC also strongly implied that the costs of certain alternatives—i.e., derivatives subject to future regulation under Title VII of the Dodd-Frank Act—will soon rise and apparently drive traders back to NMS securities.²⁰

POTENTIAL CONFLICT WITH NON-US PRIVACY LAWS

Although the SEC acknowledged the concerns of commenters that the request for identifying information on Form 13H may violate privacy laws in certain non-US jurisdictions, the SEC did not grant relief in the rule to accommodate directly such privacy laws. Instead, the SEC stated that exemptions could be requested and granted on a case-by-case basis under Rule 13h-1(g) and Exchange Act Section 36.²¹ It is not clear what criteria the SEC might use to assess the restrictions imposed by non-US privacy laws.

UNCERTAINTY FOR JOINTLY OWNED LARGE TRADERS

As noted above, in determining large trader status, a person must consider the trading activity of any entity it controls, in addition to its own activity. In the case of a large trader that is jointly owned by two or more persons, each of whom has an equal ownership interest that meets or exceeds the 25 percent control threshold (e.g., two partners in a joint venture with a 50/50 split), it is unclear who controls the large trader for purposes of applying the rule. Under the rule, all such equal joint 25+ percent owners would be presumed by the SEC to “control” this large trader, therefore requiring all of those partners to count the trader’s activity, along with their own respective trading activities, to determine whether the identifying activity level has been met. To avoid double-counting, the SEC should clarify that the presumption of control is effectively rebutted by joint owners under these circumstances if another joint owner assumes responsibility for counting the large trader’s transactions.

Endnotes

¹ Exchange Act Release No. 64,976 (July 27, 2011), 76 Fed. Reg. 46,960 (August 3, 2011) (Adopting Release). The SEC also is contemplating the adoption of a consolidated audit trail. *See* Exchange Act Release No. 62,174 (May 26, 2010), 75 Fed. Reg. 32,556 (June 8, 2010). The consolidated audit trail would effectively capture order event information for most orders in NMS securities. If adopted, the consolidated audit trail might supplant the large trader reporting system, and the SEC expects to consider the interaction of Rule 13h-1 with any future implementation of the consolidated audit trail.

² Rule 13h-1(a)(5) defines “NMS security” by referring to Rule 600(b)(46) of the SEC’s Regulation NMS. This provision of Regulation NMS, in turn, defines “NMS security” to be “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.”

³ *See* Exchange Act Release No. 29,593 (August 22, 1991), 56 Fed. Reg. 42,550 (August 28, 1991) and Exchange Act Release No. 33,608 (February 9, 1994), 59 Fed. Reg. 7,917 (February 17, 1994). *See also* Exchange Act Release No. 44,494 (June 29, 2001), 66 Fed. Reg. 35,836 (July 9, 2001) (noting that the enhancement of the Electronic Blue Sheets system provides “more efficient and cost-effective ... reviews of the activities of large traders ...” than a large trader reporting system).

⁴ *See* Exchange Act Release No. 61,908 (April 14, 2010), 75 Fed. Reg. 21,456 (April 23, 2010) (Proposing Release).

⁵ *See* Exchange Act Release No. 61,358 (January 14, 2010), 75 Fed. Reg. 3,594 (January 21, 2010).

⁶ The joint study took the SEC and US Commodity Futures Trading Commission (CFTC) over four months to complete. *See Findings Regarding the Market Events of May 6, 2010* (September 30, 2010), available at <http://www.sec.gov/news/studies/2010/marketevents-report.pdf>.

⁷ Rule 13h-1(a)(3) 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 clarifies further that a person who directly or indirectly has the right to vote or direct the vote of 25 percent or more of a class of voting securities of an entity, or who has the power to direct a sale of 25 percent or more of securities or who has the right to receive 25 percent or more of the capital upon dissolution, faces a presumption of control.

⁸ “Investment discretion” is defined in Rule 13h-1(a)(4) by reference to Section 3(a)(35) of the Exchange Act and

includes persons “authorized to determine what securities or other property shall be purchased or sold by or for the account.” This includes proprietary trading and discretionary client hedging activities, but does not include transactions necessitated by death or judicial order.

⁹ Rule 13h-1(a)(6) defines “transactions” to exclude certain seemingly unimportant or non-volitional transactions, such as gifts, certain grants of employee stock options, purchases or sales pursuant to the exercise or assignment of an option contract, and issuer tender offers/buybacks.

¹⁰ This raises the possibility that a non-US large trader could execute trades in NMS securities in the so-called third market (i.e., off-exchange) with an SEC-registered broker-dealer domiciled outside the United States and thereby not technically fit within the statutory definition of a large trader. In that case, it appears to be an open question whether the broader text of the definition of large trader in the rule (without a direct jurisdictional nexus clause) would apply. It is important to note that Section 929P of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) amended the antifraud provisions of the federal securities laws to reach conduct occurring outside the United States, if such conduct has a foreseeable substantial effect within the United States. This provision, added years after 13(h) was added to the Exchange Act, apparently evidences the SEC’s regulatory goal of projecting extraterritorially in at least some contexts without a direct jurisdictional nexus.

¹¹ See Adopting Release at 46,985.

¹² See Adopting Release at 46,970.

¹³ See Adopting Release at 46,987-46,988.

¹⁴ See Adopting Release at 46,975-46,976.

¹⁵ For large, complex organizations, the SEC believes that capturing data from the parent entity is more efficient and comprehensive. See Adopting Release at 46,965. The parent itself may assign LTID suffixes to its large trader subsidiaries in the parent’s Form 13H filing. These suffixes presumably will assist the parent and/or the SEC in monitoring transactions by subsidiaries.

¹⁶ Like any other putative large trader, an SEC-registered broker-dealer that exercises discretion over customer accounts, or that conducts proprietary trading, must file a Form 13H upon crossing the identifying activity levels. SEC-registered broker-dealers must aggregate their trading activity for all accounts over which they exercise investment discretion. The SEC estimates that this requirements will affect roughly 300 SEC-registered broker-dealers. See Adopting Release at 46,985.

¹⁷ While the SEC noted that it anticipates infrequent use of this immediate access provision, it wrote the rule with

extreme events like the Flash Crash in mind. See Adopting Release at 46,976-46,977.

¹⁸ See Adopting Release at 46,981. Thus, the SEC reads the Form 13H disclosure to apply to “broker-dealers” without the modifier “registered.”

¹⁹ See Letter from the European Banking Federation and the Swiss Bankers Association dated October 21, 2010, available at <http://sec.gov/comments/s7-10-10/s71010-92.pdf>. Indeed, the SEC also specifically noted this as a concern in the Proposing Release at 21,473 (“Would the large trader reporting requirements influence the day-to-day decisions made by large traders in any substantive way?... For example, might traders choose in some cases to avoid trading in equities or options in favor of alternative vehicles such as OTC derivatives to avoid reporting?... Might they trade in foreign jurisdictions?”).

²⁰ See Adopting Release at 46,982.

²¹ *Id.*

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