

SEC's Large Trader Reporting System Proposal Would Affect Large-Volume, High-Frequency Traders and Their Broker-Dealers

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On April 14, the Securities and Exchange Commission (SEC) issued a release (Release) proposing that certain large-volume, high-frequency traders (classified as "large traders") be required to self-identify to the SEC, and that broker-dealers that effect transactions for "large trader" customers maintain and produce records of these customers' trades to the SEC.¹ Proposed Rule 13h-1 under the Securities Exchange Act of 1934 (Rule) is intended to bolster the SEC's regulatory and enforcement capabilities by increasing its ability to obtain information about the activities of large-volume, high-frequency traders. If adopted, the Rule will require such "Large Traders" of exchange-listed stocks and options to self-report to the SEC and will impose recordkeeping, reporting, and monitoring requirements upon registered broker-dealers' transactions with "large trader" customers for production to the SEC upon request. Comments on the Rule are due by June 22, 2010.

Who Is a "Large Trader"?

Under the Rule, a "Large Trader" is defined as any person who, directly or indirectly (including through other persons "controlled" by such person), exercises investment discretion² over one or more accounts and effects transactions in U.S. exchange-listed stocks and options for those accounts by or through one or more registered broker-dealers that, in the aggregate, exceed either (i) \$20 million or 2 million shares per day, or (ii) \$200 million or 20 million shares per month. Large Traders would include advisers to private and registered funds, pension plans, insurance companies, and other institutional investors.

In calculating the daily or monthly transaction amounts, the value of purchases and sales of stocks and options is aggregated without netting or offsetting. However, certain transactions are exempt under the Rule.³

In complex organizations, parent companies would be deemed Large Traders if, in the aggregate, their subsidiaries meet the daily or monthly transaction thresholds—even if the parent company itself does not trade securities. In the Release, the SEC noted that the focus in complex organizations should be on a parent company that employs or controls entities or individuals with investment discretion over accounts.⁴ Foreign entities that trade on U.S. exchanges could also be deemed Large Traders if they meet the applicable daily or monthly

¹ Large Trader Reporting System (Proposing Release), Exchange Act Release No. 61,908 (Apr. 14, 2010), available at <http://www.sec.gov/rules/proposed/2010/34-61908.pdf>.

² The Release 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.

³ For example, offerings of securities by or on behalf of an issuer that take place outside of a national securities exchange, rollover transactions in qualified plans or trusts, or transactions as part of an issuer benefit plan or compensatory arrangement between an employer and employee are all exempt from the definition of "transaction" set forth under the Rule.

⁴ This is the approach taken for Form 13F reporting.

threshold. Registered broker-dealers that effect transactions for proprietary accounts at or above the daily or monthly thresholds would also be considered Large Traders. However, mere ownership of accounts without investment discretion (i.e., trusts) would not trigger Large Trader status.

Obligations of Large Traders

Register with the SEC on Form 13H. Large Traders would be required to self-report to the SEC by promptly filing Form 13H. A parent company may register as a Large Trader on behalf of its subsidiaries or its subsidiaries may collectively register as a Large Trader. If a parent company files Form 13H, the form covers all accounts over which a controlled person of the parent company exercises investment discretion.

Form 13H would require a Large Trader to disclose the following:

1. Information about its business and organization
2. Whether any of its affiliates file forms with the SEC and if so, which forms
3. Whether it or its affiliates are registered, as traders or otherwise, under the Commodities Exchange Act, or are a bank holding company, bank, savings bank or association, credit union, foreign bank, or insurance company
4. The names and Large Trader identification numbers (discussed below) of any affiliates that are Large Traders
5. The names of any general partners or limited partners that own more than 10% of the accounts of the Large Trader
6. The names of any officers, directors or trustees of the Large Trader
7. The jurisdiction(s) in which the Large Trader is organized and maintains its principal place of business
8. For each account over which the Large Trader exercises investment discretion
 - a. The name of broker-dealer that holds the account
 - b. The account number
 - c. The name of the account
 - d. The identification number of any other Large Traders that exercise discretion over the account. Form 13H, as proposed, does not contain a *de minimis* exception for retail or smaller accounts.

Provide Broker-Dealers and Affiliates with Identification Number. Upon registration with the SEC, Large Traders will receive a unique Large Trader Identification Number (LTID) from the SEC. The Large Trader must disclose its LTID to every registered broker-dealer that effects transactions on its behalf and identify each account held by such broker-dealer to which the LTID applies. The Rule would also require a Large Trader to disclose its LTID to others with whom it collectively exercises investment discretion.

Periodically Update Form 13H. Large Traders would be required to promptly amend Form 13H at the end of each quarter if any information contained in the previously filed Form 13H had become inaccurate. An investment adviser with registered fund and institutional clients as well as many wrap account clients could meet the definition of Large Trader, and thus would likely have to amend Form 13H each quarter to reflect new and terminating wrap clients. Even without any changes to a Large Trader's Form 13H, the Rule would require a Large Trader to annually file a new Form 13H within 45 days of the calendar year-end.

Requirements for Registered Broker-Dealers

Monitoring Customer Transactions for Large Trader Status. The Rule would impose obligations upon registered broker-dealers with respect to any customer that the broker-dealer knows or has reason to know is a Large Trader, but has not self-reported to the SEC. The Release deems these customers "Unidentified Large Traders." Registered broker-dealers would be required to maintain records of, and report transactions to the SEC effected by, such Unidentified Large Traders. However, the Rule would provide a safe harbor from the recordkeeping and reporting obligations with respect to Unidentified Large Traders if a broker-dealer (i) does not have actual knowledge that an entity is a Large Trader, and (ii) has established policies and procedures reasonably designed to detect and identify Unidentified Large Traders. The SEC may also require registered broker-dealers to notify Unidentified Large Traders of their obligation to self-report to the SEC.

Recordkeeping. The Rule would require registered broker-dealers to maintain the following records for any transaction in excess of 100 shares of exchange-listed securities or options effected directly or indirectly through a Large Trader or Unidentified Large Trader's account:

1. The transaction date and price
2. Account number
3. Identifying symbol of the security (i.e., ticker symbol)
4. Number of shares or options contracts traded and type of transaction
5. Clearing house number
6. Whether the transaction was proprietary or agency
7. Name of exchange or market where transaction was effected
8. Execution time
9. LTIDs associated with the account
10. Prime broker identifier, if any
11. Average price account identifier, if any
12. Identified assigned by depository institution, if applicable.⁵

Reporting to SEC. Registered broker-dealers would be required to have records available the day after a transaction is effected. Upon request from the SEC, a registered broker-dealer must provide information to the SEC by the close of business on the same day as the request.

Foreign Entities. Foreign broker-dealers that are not registered in the United States would not be subject to the monitoring, recordkeeping, and reporting requirements under the Rule. However, foreign entities that fit the definition of Large Trader would be required to self-report to the SEC; thus, registered broker-dealers would be obligated to monitor foreign customer transactions for qualification as Large Traders and also maintain records for foreign entities that either self-report as Large Traders or are Unidentified Large Traders.

Open Issues

Implementing a large trader reporting system is a significant task, evidenced by the SEC's two prior attempts to do so.⁶ The Release prompts a number of open questions and unresolved issues, including the following:

- Under the Rule, a single large transaction (i.e., 2 million shares or \$20 million) would trigger a year's worth of reporting requirements.
- Although information submitted to the SEC by a registered broker-dealer or a Large Trader on Form 13H would be kept confidential and would not be subject to Freedom of Information Act requests, brokerage account names and numbers are sensitive material.
- Large Traders would be required to self-report within three months of the final rule becoming effective, and registered broker-dealers would be required to maintain and provide to the SEC records of Large Trader and Unidentified Large Trader transactions within six months of the final rule becoming effective. Given the need to obtain, review, and report information and, in the case of registered broker-dealers, adopt policies and procedures reasonably designed to identify Large Trader customers, this expedited time frame may prove difficult and costly.
- Many U.S. and foreign market participants will be required to self-report to the SEC under the rule; many of these entities have no prior experience with the SEC.
- Because the Rule is limited to U.S. exchange-traded securities and options, the Rule could actually provide an incentive to increase holdings in derivatives, futures, swaps, and other investment products that provide exposure directly coupled to the exchange traded instrument, but would not be reportable. This appears to be contrary to the intent of the Rule.

⁵ The Release notes that the only records that are not already required under Rule 17a-25 and the Electronic Blue Sheet system are the LTID and the transaction time.

⁶ See Exchange Act Release No. 33608 (Feb. 9, 1994) and Exchange Act Release No. 29593 (Aug. 22, 1991).

- The Rule could have a disparate impact on complex entities because they either will have to register as Large Traders at the parent-company level (even if the parent company is significantly distant from any trading activity) or adopt policies to ensure that all Large Trader subsidiaries have registered.
- The Rule presumes “control” of an entity upon ownership of 25% of its voting securities, but the information required by Form 13H—such as account names and numbers—may not be available to an entity with a minority (i.e., less than 50%) interest in a subsidiary. In this situation, the investor will either have to contract to obtain the information or have evidence to demonstrate that it does not control the entity.
- Because “insiders” are unlikely to trade under the same LTID, it is unlikely that the Rule would increase the SEC’s ability to detect tipper-tippee and other insider trading schemes. Further, the Rule seems unlikely to increase the SEC’s ability to detect Ponzi schemes, which, by their very nature, collect funds from investors without engaging in equivalent investment transactions.
- The Rule would likely promote the use of foreign markets to effect transactions in U.S. securities, which could have the opposite effect of promoting market fairness and efficiency as many foreign markets are less transparent and regulated than U.S. markets.

Implications

If adopted, the Rule could significantly affect the investment activities, recordkeeping, and reporting requirements and compliance policies and procedures of many large-volume, high frequency traders and the broker-dealers that such traders utilize to effect transactions in exchange-listed options and securities. These firms may want to consider providing the SEC with comments in response to the Release prior to June 22, 2010.

Morgan Lewis will continue to monitor this and other financial industry regulatory developments. If you would like more information or have any questions about any of the issues discussed in this FYI, please contact any of the following Morgan Lewis attorneys:

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