

**SEC PROPOSES LARGE TRADER REPORTING SYSTEM**

Continuing its efforts in the areas of market structure and securities trading, the SEC has proposed<sup>1</sup> to adopt Rule 13h-1 under Section 13(h)<sup>2</sup> of the Securities Exchange Act of 1934 (the “Exchange Act”) to establish a large trader reporting system. Proposed Rule 13h-1 (the “Proposed Rule”) would:

- define who would be a large trader for purposes of the Rule;
- require such persons to identify themselves to the SEC by filing proposed Form 13H with the SEC and to obtain from the SEC upon such filing a large trader identification number (“LTID”);
- require large traders to provide the LTID to each broker-dealer through which they effect transactions in NMS securities;
- require broker-dealers to provide to the SEC, upon request, data on large traders’ transactions in NMS securities by the morning after the transactions are effected; and
- require broker-dealers to maintain books and records with respect to those transactions.

After submitting to the SEC proposed Form 13H as an “Initial Filing” and receiving its LTID, a large trader would have to submit various periodic amendments. All Form 13H filings would be confidential.

According to the SEC, “a large trader reporting system is necessary because ... large traders appear to be playing an increasingly prominent role in the securities markets.”<sup>3</sup> The reporting system would provide information that “would facilitate the Commission’s efforts both to

---

<sup>1</sup> Large Trader Reporting System, Exchange Act Release No. 61908 (Apr. 14, 2010) (the “Proposing Release”) available at <http://www.sec.gov/rules/proposed/2010/34-61908.pdf>. Please note that proposed Form 13H, which requires a large trader to provide detailed information about itself and its affiliates, is attached to the end of the Proposing Release.

The appendix to this memorandum lists and describes the SEC’s recent market structure and securities trading initiatives.

<sup>2</sup> 15 U.S.C. 78m(h) (2010). Following the 1987 market break and as part of the Market Reform Act of 1990, Congress added subsection (h) to Exchange Act Section 13 in an effort “to facilitate the Commission’s ability to monitor the impact on the securities markets of securities transactions involving substantial volume or large fair market value, as well as to assist the Commission’s enforcement of the federal securities laws.” Proposing Release at 7.

<sup>3</sup> *Id.* at 13.

investigate potential manipulative activity and to reconstruct a more accurate market history.”<sup>4</sup> The SEC made it clear, both in the Proposing Release and at the open meeting at which it voted to propose Rule 13h-1, that it intends the large trader reporting system to play a significant enforcement role.

Comments on the Proposed Rule are due 60 days after the date of the publication of the Proposing Release in the Federal Register. Large traders would be required to comply with the rule within three months after its adoption; broker-dealers would be subject to a six-month implementation period.

### **Definition of “Large Trader” and Basic Filing Requirements**

Under paragraph (a)(1) of the Proposed Rule, a “large trader” would be “any person that directly 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.” The “identifying activity level” would be defined in paragraph (a)(7) of the Proposed Rule to mean “aggregate transactions in NMS securities that are equal to or greater than: (1) during a calendar day, either two million shares or shares with a fair market value of \$20 million dollars; or (2) during a calendar month, either twenty million shares or shares with a fair market value of \$200 million.”

Proposed Paragraph (b) would subject a large trader to specified identification requirements. Paragraph (b)(1) would require a large trader to identify itself to the SEC by filing proposed Form 13H “promptly after first effecting aggregate transactions ... equal to or greater than the identifying activity level.” Proposed Form 13H is discussed in greater detail below. Proposed paragraph (b)(2) would require the large trader to “disclose to the registered broker-dealers effecting transactions on its behalf its [LTID] and each account to which it [the LTID] applies.”<sup>5</sup> Proposed paragraph (b)(4) would require the large trader to provide promptly such additional descriptive or clarifying information as the SEC requests to assist it in further identifying the large trader and all accounts through which the large trader effects transactions.

### **Large Traders in Complex Organizations**

Under proposed paragraph (b)(3)(i), a large trader would not be subject to the large trader identification requirements if the person who controls the large trader complies with those requirements. “The intent of this proposed provision is to push the identification requirement up the corporate hierarchy to the parent entity to identify the primary institutions that conduct a

---

<sup>4</sup> Proposing Release at 12.

<sup>5</sup> Proposed paragraph (b)(2) would require each large trader to disclose its LTID to others with whom it collectively exercises investment discretion.

large trading business.”<sup>6</sup> If natural persons or subsidiary entities within a larger organization independently qualify as large traders, but the parent company identifies itself to the SEC and broker-dealers as the large trader, the natural persons or subsidiary entities would not also have to identify themselves as large traders or to comply with applicable rules.

Paragraph (b)(3)(ii) would relieve a large trader from having to comply with the identification requirements in paragraph (b) of the Proposed Rule “if one or more persons controlled by such large trader collectively comply with all of the requirements under paragraphs (b)(1), (b)(2), and (b)(4) applicable to such large trader with respect to all of its accounts.” Unless all the large traders that it controls have identified themselves to the SEC with respect to all accounts of the controlling person, however, a controlling person still would have to comply with paragraph (b). If, for example, a holding company has two large trader subsidiaries, only one of which elects to file its own Form 13H, the holding company would have to file its own Form 13H that includes both subsidiaries.<sup>7</sup>

In focusing on parent companies, the SEC intends large traders “to aggregate accounts over which persons they control exercise investment discretion.”<sup>8</sup> That is, even if any individual employee, group or subsidiary entity within a company would not qualify as a large trader, if such employees, groups or subsidiaries acting collectively would qualify as a large trader, *i.e.*, effect transactions that meet or exceed the identifying activity level threshold, the parent company would be required to identify itself as a large trader. Consequently, for example, a company could not avoid identifying itself as a large trader by allocating its trading among subsidiary entities.

### **“Person,” “Control” and “Investment Discretion” Under the Proposed Rule**

Central to determining who is a large trader for purposes of complying with the Proposed Rule are the definitions of “person,” “control” and “investment discretion.” Paragraph (a)(2) of the Proposed Rule would assign “person” the meaning set out in Section 13(h)(8)(E) of the Exchange Act. Section 13(h)(8)(E), in turn, incorporates the meaning set out in Section 3(a)(9) of the Exchange Act and includes “two or more persons acting as a partnership, limited partnership, syndicate, or other group, but does not include a foreign central bank.”<sup>9</sup> Section 3(a)(9) of the Exchange Act defines the term “person” to include, among others, a natural person or company.<sup>10</sup>

---

<sup>6</sup> Proposing Release at 17.

<sup>7</sup> *Id.* at 19. Both the holding company and the large trader subsidiary would identify the other as an affiliated large trader on Form 13H.

<sup>8</sup> *Id.* at 24.

<sup>9</sup> 15 U.S.C. 78mm(h)(8)(E) (2010).

<sup>10</sup> 15 U.S.C. 78c(a)(9) (2010).

Under paragraph (a)(3), “control”<sup>11</sup> would be defined 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.” Under this definition, an investment adviser to multiple private funds with separate portfolio managers arguably would control those funds. Furthermore, any person who (1) has the direct or indirect right to vote or direct the voting of 25% or more of a class of an entity’s voting securities, or (2) the power to sell or direct the sale of 25% or more of a class of voting securities of such an entity (or, in the case of a partnership, has the right to receive upon dissolution, or has contributed, 25% or more of the partnership’s capital) is presumed to control the entity.

Paragraph (a)(4) would assign “investment discretion” the meaning set out in Exchange Act Section 3(a)(35), which provides that a person exercises investment discretion with respect to an account if such person, directly or indirectly, (1) may determine which securities or other property are purchased or sold by or for the account, (2) determines which securities or other property are purchased by or for an account even if other persons may have responsibility for investment decisions, or (3) “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 ... should be subject to the operation of the provisions” of the Exchange Act.<sup>12</sup>

### **Transactions and NMS Securities**

The term “transaction” or “transactions,” for purposes of determining if a person has effected transactions in NMS securities at or exceeding the identifying level, means all transactions in NMS securities, other than the seven types of transactions specifically exempted in paragraph (a)(6) of the Proposed Rule. Those transactions include: (i) journaling/booking entries to record the receipt or delivery of funds or securities in settling a transaction; (ii) an offering of securities, other than an offering effected through the facilities of a national securities exchange; (iii) a gift of securities; (iv) distribution of securities that are part of a decedent’s estate; (v) a transaction effected pursuant to a court order or judgment; (vi) a rollover of a qualified plan or trust; and (vii) an award, allocation, sale, grant or exercise of an NMS security, option or other right to acquire the securities at a pre-determined price pursuant to a compensatory arrangement.

“NMS security” would have the meaning assigned in Rule 600(b)(46) under the Exchange Act, and means “any security or class of securities for which transactions 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.”<sup>13</sup> The Proposed Rule would apply to trading in NMS securities effected through any facility of a national securities exchange, in domestic over-the-counter (“OTC”) markets, in foreign OTC markets, or through after-hours systems.

---

<sup>11</sup> Control would include “controlling,” “controlled by,” and “under common control with.”

<sup>12</sup> “A person’s employees would be deemed to exercise investment discretion on behalf of that person when they act within the scope of their employment.” Proposing Release at 25.

<sup>13</sup> 17 CFR 240.600(b)(46) (2010).

## Identifying Activity Level

The Proposed Rule would require participants to use a “gross up” approach in calculating identifying activity levels. “Offsetting or netting transactions among or within accounts, even or hedged positions, would be added to a participant’s activity level in order to show the full extent of a trader’s purchase and sale activity.”<sup>14</sup> This means that in addition to aggregating the volume or market value of purchases and sales of NMS securities, including short sales, the market value of transactions in options or on a group or index of equity securities would also be aggregated under paragraph (c) of the Proposed Rule. With respect to options, only purchases and sale, not exercises, would be included. The proposed aggregation approach means that if a person purchased, say, 50,000 shares of XYZ stock and 800 XYZ call options, the aggregation provisions of the proposed rules would view those purchases as constituting transactions in 130,000 shares of XYZ (50,000 shares purchased + 800 option contracts times 100 shares of XYZ per contract).

Proposed Rule 13h-1(b)(3)(iii) would permit an optional inactive status. A large trader would be permitted to go on “inactive status” if during the previous full calendar year, it did not reach the identifying activity level.

## Form 13H

As discussed above, a large trader would be required to submit to the SEC proposed Form 13H as an “Initial Filing” to receive its LTID. After receiving its LTID, it would need to submit promptly an “Interim Filing” to include the LTID and any new information. A large trader would make an Interim Filing promptly following each calendar quarter if any information contained in its Form 13H became inaccurate. It would be required to submit an “Annual Filing” 45 days after the end of each full calendar year irrespective of whether any information on the Form 13H had become inaccurate. An “Inactive Status” filing would be made if a large trader met the criteria for such status and chose to become inactive. If the person once again became a large trader, it would submit a “Reactivated Status” filing. Finally, a large trader would submit a “Termination Filing” to terminate such status permanently. As noted above, all Form 13H filings would be confidential.

Proposed Form 13H would require the large trader to submit substantial information about itself and certain of its affiliates. Proposed Item 1 to Form 13H would require a large trader to check the box that best describes its business, for example, hedge fund, investment adviser or broker-dealer, among others. Proposed Item 2 would require a large trader to state whether it, or any of its affiliates, files any forms with the SEC and, if so, to identify the types of forms, together with SEC File and CRD numbers.

---

<sup>14</sup> Proposing Release at 31.

Proposed Item 3 would require a large trader to state whether it or any of its affiliates is: (1) registered with the Commodity Futures Trading Commission (“CFTC”); (2) a banking institution; (3) an insurance company; or (4) regulated by a foreign regulator. If any large trader or affiliate were such an entity, it would be required to provide additional information, such as a CFTC registration number.

Proposed Item 4 and Schedule 4 would require the large trader to disclose certain business information, including whether it exercises investment discretion as a trustee, partnership or corporation, and to describe the nature and organizational structure of the business. Entities would be required to identify “those persons who own or control a large trader corporation, partnership, limited partnership, or trust.”

Proposed Item 5 would require the large trader to identify any affiliates (persons that control, are controlled by, or under common control with, the large trader) that either exercise discretion over the accounts that hold NMS securities or beneficially own NMS securities.

Finally, proposed Item 6, together with Schedule 6, would require a large trader to list all accounts over which it exercises investment discretion.

### **Broker-Dealer Reporting, Recordkeeping and Monitoring Obligations**

Paragraph (d)(5) of the Proposed Rule would require a broker-dealer to disclose large trader “reporting level activity” (discussed below), upon the SEC’s request, by the morning after the day on which transactions in the NMS securities were effected. The broker-dealer would need to produce the data by the close of business on the day on which the SEC requests the information.

Under proposed paragraph (e), the information would be disclosed through the existing Electronic Blue Sheets (“EBS”) system,<sup>15</sup> as modified to accommodate the large trader reporting system. Specifically, fields for the LTID and execution time of the large traders transactions in NMS securities would be added to the EBS system.

The Proposed Rule would impose certain recordkeeping requirements on broker-dealers. Paragraph (d)(1) of the Proposed Rule would require a broker-dealer to maintain records of specified information for all transactions effected directly or indirectly through (i) an account that the broker-dealer maintains for a large trader or Unidentified Large Trader,<sup>16</sup> (ii) an account over which the broker-dealer exercises investment discretion together with a large trader or an Unidentified Large Trader, or (iii) if the broker-dealer is a large trader, any proprietary or other account over which the broker-dealer exercises investment discretion.

---

<sup>15</sup> Rule 17a-25 governs the EBS system. 17 CFR 240.17a-25 (2010).

<sup>16</sup> An “Unidentified Large Trader” would be a person who meets the definition of large trader but has not self identified to the SEC and whom a broker-dealer knows or has reason to know is a large trader. Proposed Rule 13h-1(a)(9).

Paragraph (d)(2) would require the broker-dealer to maintain various pieces of information about a large trader's transactions including, among others, account numbers, dates of execution, security symbols, transaction prices, number of shares or options subject to the transactions, whether the transactions were effected for customers or on a proprietary basis, the identity of the market centers where the transactions were executed, times of execution, LTID, prime broker identifiers, average price account identifiers, and depository account identifiers, if applicable. With respect to an Unidentified Large Trader, in addition to the preceding, the broker-dealer also would be required under proposed paragraph (d)(3) to retain and report such person's name, address, date the account was opened and tax identification number(s).

Under proposed paragraph (e), a broker-dealer would have to report only transactions that equal or exceed the "reporting level activity." Proposed paragraph (a)(8) would define "reporting level activity" to include (i) each transaction in NMS securities, effected in a single calendar day, that is at least 100 shares; (ii) any other transactions in NMS securities, effected in a single calendar day, that the broker-dealer deems appropriate; or (iii) other levels that the SEC designates. Reporting level activity would be determined on an account-by-account basis, *i.e.*, not aggregated across accounts.

An account could have multiple LTIDs. For transactions in these accounts, the broker-dealer would be required to record each LTID for each transaction effected in the account.

Paragraph (f) of the Proposed Rule would establish a "safe harbor" with respect to the duty to monitor for Unidentified Large Traders. A broker-dealer would not be deemed to know or have reason to know that a person is an Unidentified Large Trader if it (i) does not have actual knowledge that a person is a large trader, and (ii) establishes and maintains policies and procedures reasonably designed to assure compliance with the identification requirements of the safe harbor. The broker-dealer's monitoring policies and procedures would need to contain systems reasonably designed to inform persons about their obligations to file proposed Form 13H.

## **Considerations**

The proposed large trader reporting system raises a number of issues, particularly with respect to entities that are not SEC registrants, such as private funds. The Proposed Rule and proposed Form 13H would require any entity, including a private fund or a foreign entity, to provide detailed identifying information about the large trader and its affiliates. Moreover, the Proposed Rule would enable the SEC staff to monitor such entities' securities trading on an ongoing basis and seek information about such trading, potentially for use in enforcement proceedings.

The Proposed Rule also raises issues as to which legal entity within a complex organization would be the large trader for purposes of compliance with the rule. Large hedge fund complexes, for example, might use a structure that includes an ultimate holding company, one or more intermediate holding companies and multiple investment advisers. Determining which entity or entities within such a structure have "control" for purposes of self identifying as large traders may be a complicated undertaking.

It may not be possible for large traders within a hedge fund “family” to identify themselves at the individual fund level if some of the funds in that family would qualify as large traders, but others would not. If, for example, an investment adviser were an adviser to four funds, Funds One through Four (each of which has a separate portfolio manager), and if Funds One through Three would qualify as large traders, but Fund Four would not, compliance with the Proposed Rule arguably would not be possible at the individual fund level. Funds One through Three could comply with the requirements of the Proposed Rule and proposed Form 13H, but Fund Four would not be subject to those requirements because it would not be a large trader. Nevertheless, because an organization must aggregate its transactions in NMS securities across the organization for purposes of complying with the Proposed Rule, Fund Four’s NMS trading activity would be aggregated with the other Funds’ trading activities, thereby necessitating the investment adviser to comply with requirements of the Proposed Rule instead of complying with the Rule at the individual fund level.

Finally, we note that the Proposed Rule is intended to give the SEC visibility into the securities trading activities of large traders, but would also impose potentially significant burdens on the broker-dealers the large traders use. The Proposed Rule would require broker-dealers to establish policies and procedures reasonably designed to detect and identify Unidentified Large Traders and inform such traders of their obligations to file Form 13H and to disclose their status to the broker-dealers they use. Therefore, as a result of the SEC's attempts to monitor the activities of third parties, not only would broker-dealers need to establish and maintain these Unidentified Large Trader monitoring systems, they would also face the regulatory risk of being cited for failure to supervise if regulators were to later determine that the monitoring systems are inadequate.

\* \* \* \* \*

If you have any questions regarding this memorandum, please contact Roger D. Blanc (212-728-8206, rblanc@willkie.com), Martin R. Miller (212-728-8690, mmiller@willkie.com), Matthew B. Comstock (202-303-1257, mcomstock@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, DC 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, DC telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at [www.willkie.com](http://www.willkie.com).

April 22, 2010

Copyright © 2010 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York’s Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.

## APPENDIX

## RECENT SEC MARKET STRUCTURE/SECURITIES TRADING INITIATIVES

Action	Description	Reference
Proposed Flash Trading Ban	The SEC has proposed a rule amendment to Rule 601 of Regulation NMS under the Securities Exchange Act of 1934 (the “Exchange Act”) to ban so-called “flash orders.”	Release: <a href="#">Elimination of Flash Order Exception from Rule 602 of Regulation NMS</a> , Exchange Act Release No. 60684, 74 Fed. Reg. 48632 (Sept. 23, 2009).  Willkie Memo: <a href="#">SEC Proposes to Ban Flash Trading</a> .
Increased Disclosure by “Dark Pools”	The SEC has proposed to increase the regulation of alternative trading systems that publicly display quotations in the consolidated quotation data, so-called “dark pools.”	Release: <a href="#">Regulation of Non-Public Trading Interest</a> , Exchange Act Release No. 34-60997, 74 Fed. Reg. 61209 (Nov. 23, 2009).  Willkie Memo: <a href="#">SEC Proposes to Increase Disclosure by Dark Pools</a> .
Market Structure Concept Release	The SEC has requested comment on a variety of market structure issues, including the efficacy of the current market structure, the impact of high-frequency trading on the markets, and “dark” liquidity concerns, such as market fragmentation.	Release: <a href="#">Concept Release on Equity Market Structure</a> , Exchange Act Release No. 61358, 75 Fed. Reg. 3594 (Jan. 21, 2010).  Willkie Memo: <a href="#">Further SEC Action on Market Structure Issues</a> .
Proposed Ban on “Naked” Access	The SEC has proposed Rule 15c3-5, which would effectively prohibit a broker-dealer from providing customers with “unfiltered” or “naked” access to an exchange or alternative trading system.	Release: <a href="#">Risk Management Controls for Brokers or Dealers with Market Access</a> , Exchange Act Release No. 61379, 75 Fed. Reg. 4007 (Jan. 26, 2010).  Willkie Memo: <a href="#">Further SEC Action on Market Structure Issues</a> .

<b>Action</b>	<b>Description</b>	<b>Reference</b>
Adoption of Short Sale Price Test	The SEC has adopted Rule 201 as part of Regulation SHO under the Exchange Act. The rule restricts the prices at which a security may be sold short if the price of that security decreases by 10% or more from the prior day's closing price.	<p>Release: <a href="#">Amendments to Regulation SHO</a>, Exchange Act Release No. 61595, 75 Fed. Reg. 11232 (Mar. 10, 2010).</p> <p>Willkie Memo: <a href="#">SEC Adopts Short Sale Price Test</a>.</p>