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**Legal Risk Management Tip**
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## HOW NEW RULE 13H-1 AFFECTS INVESTMENT ADVISERS AND BROKER-DEALERS

On October 3, 2011, Rule 13h-1 under the Securities Exchange Act of 1934 ("Exchange Act") went into effect, which requires, among other things, that large traders identify themselves to the Securities and Exchange Commission ("SEC" or "Commission") by filing certain information on Form 13-H, and that broker-dealers perform certain steps and maintain records in connection with the transactions executed for the accounts of large traders.[1] This Legal Tip provides an overview of Rule 13h-1, including the definition of "large trader," and outlines the steps required by investment advisers and broker-dealers affected by the rule.

### 1. Background and Overview

Shortly after the stock market crashes of 1987 and 1989, Congress passed the Market Reform Act of 1990 ("Market Reform Act") in order to provide the SEC with the ability to implement rules and systems that would allow for the identification of large traders and reporting of certain transactional information pertaining to such large traders. Through the Market Reform Act, Congress amended Section 13 of the Exchange Act by adding subsection 13(h), which granted the SEC the authority to require self-reporting by large traders and to collect detailed information on the trading activity of large traders from registered broker-dealers. Since the granting of such authority, the SEC has issued three separate proposals for the implementation of a large trader reporting system,[2] with the last proposal being issued in April 2010.

The SEC formally adopted Rule 13h-1 on July 27, 2011, stating that "[g]iven the dramatic changes to the securities markets, the Commission believes it is appropriate to exercise its authority under Section 13(h) of the Exchange Act to establish large trader reporting requirements."[3] In the adopting release of Rule 13h-1, the SEC stated the purpose behind the new rule as follows:

> The large trader reporting requirements are designed to provide the Commission with a valuable source of useful data to support its investigative and enforcement activities, as well as facilitate the Commission's ability to assess the impact of large trader activity on the securities markets, to reconstruct trading activity following periods of unusual market volatility, and to analyze significant market events for regulatory purposes.[4]

The reporting system required under final Rule 13h-1, has the following two main parts: (1) the registration and periodic filing of Form 13-H by persons or firms that fall within the definition of "large

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[1] Large Trader Reporting Rule, 17 C.F.R § 240.13h-1 (2011).
[2] *See* Exchange Act Release No. 34-29,593 (Aug. 22, 1991), 56 Fed. Reg. 42,550 (Aug. 28, 1991) (File No. S7-24-91); Exchange Act Release No. 34-33,608 (Feb. 9, 1994), 59 Fed. Reg. 7917 (Feb. 17, 1994) (File No. S7-24-91); Exchange Act Release No. 34-61,908 (Apr. 14, 2010) 75 Fed. Reg. 21,456 (Apr. 23, 2010) (File No. S7-10-10).
[3] Large Trader Reporting, Exchange Act Release No. 34-64,976 (July 27, 2011), 76 Fed. Reg. 46,960 at 46,961 (Aug. 3, 2011) (File No. S7-10-10) [hereinafter Adopting Release].
[4] *Id.* at 46,960.

trader"(as described below); and (2) the reporting, recordkeeping and monitoring requirements that must be followed by registered broker-dealers that execute transactions for large traders.

**2. Definition of "Large Trader"**

Under Rule 13h-1, a "large trader" is defined as: "any person that: (i) 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; or (ii) voluntarily registers as a large trader by filing electronically with the Commission Form 13H."[5] The "identifying activity level" is outlined in the final rule as any transactions in an NMS security that in the aggregate would: (a) equal or exceed two million shares with a market price of $20 million or more on a daily basis; or (b) equal or exceed twenty million shares with a market price of $200 million or more on a monthly basis.[6]

Therefore, Rule 13h-1 will generally apply to, among others, investment advisers and broker-dealers who have discretionary authority over client assets and implement transactions for their clients in NMS securities that are, in the aggregate equal to or greater than the identifying activity level.

Importantly, there are certain transactions outlined in Rule 13h-1, which are considered exempt for the purpose of determining whether a person or firm meets the definition of large trader.

**3. Registration and Filing Requirements by Large Traders**

Upon the effectuation of aggregated transactions[7] after the applicable compliance date[8] in any NMS security that meet the identifying activity level, a large trader will be required to promptly register with the SEC by initially filing new Form 13H containing contact and business information, including type of business, regulatory status, affiliates, and a list of broker-dealers that execute transactions. Upon receipt of the initial filing, the SEC will issue a unique large trader identification number (LTID), which must be promptly disclosed by the large trader to all broker-dealers that execute trades on behalf of the large trader and/or its clients, along with each account to which the LTID applies.

After such initial filing, a large trader must file Form 13H as follows:

(i) Within 45 days after the end of each full calendar year;

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[5] 17 C.F.R § 240.13h-1(a)(1).
[6] *Id.* § 240.13h-1(a)(7).
[7] When determining whether a person or firm is a large trader, the following transactions are required to be aggregated: a) the volume or fair market value of purchase or sell transactions in equity securities and the volume or fair market value of the equity securities underlying purchase or sell transactions in options on equity securities; and (b) The fair market value of purchase or sell transactions in options on a group or index of equity securities (or based on the value thereof). *Id.* § 240.13h-1(c).
[8] The compliance date for the requirement on large traders to identify to the Commission pursuant to Rule 13h–1(b) is December 1, 2011.

(ii) Promptly after effecting aggregate transactions subsequent to becoming inactive[9], which are equal to or greater than the identifying activity level; and
(iii) Promptly after the end of any calendar quarter during which time any of the information contained in the previously filed Form 13H becomes inaccurate for any reason.[10]

For reporting purposes, a large trader is not required to separately comply with the rule's filing requirements if a person or firm that controls or is controlled by the large trader complies with the reporting and filing requirements of Rule 13h-1 on behalf of the large trader.

In addition to filing Form 13H, large traders must, upon request by the SEC, provide any additional information that would assist the SEC in further identifying the large trader and all accounts that have qualifying transactions.

**4. Recordkeeping, Reporting and Monitoring by Broker-Dealers**

Beginning April 30, 2012, registered broker-dealers are required to perform the following in compliance with Rule 13h-1:

(i) Maintain specified records of transactions effected by or through accounts of large traders as well as Unidentified Large Traders[11];
(ii) Upon request by the SEC, electronically report all transactions by such persons utilizing the existing electronic blue sheets (EBS) reporting system; and
(iii) Perform limited monitoring activities.[12]

*Recordkeeping:* The records required to be maintained must include specific information, as outlined in Rule 13h-1(d)(2) and (d)(3), regarding all transactions effected for the account(s) the registered broker-dealer carries for a large trader or an Unidentified Large Trader; or, in cases where the broker-dealer also is defined as a large trader, specific information on any proprietary or other account over which such broker-dealer exercises investment discretion.[13]

*Reporting:* If requested by the SEC, registered broker-dealers that are considered to be large traders or who hold one or more accounts for a large trader or Unidentified Large Trader are required to report the information maintained under Rule 13h-1(d)(2) and (d)(3), for all transactions executed by such broker-dealers for large traders and Unidentified Large Traders, equal to or greater than the reporting activity level.[14]

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[9] Large traders may file for inactive status by filing a Form 13H if, during the previous full calendar year, the large trader did not have any transactions in any NMS securities that were equal to or greater than the identifying activity level. Thereafter, a Form 13H filing is not required until such time as the large trader's transactions in any NMS securities again are equal to or greater than the identifying activity level. Once inactive status ends, the large trader is required to notify applicable broker-dealers of its reactivation.
[10] Adopting Release, *supra* note 3, at 46,970.
[11] The term "Unidentified Large Trader" is defined in Rule 13h-1 as "each person who has not complied with the identification requirements of paragraphs (b)(1) and (b)(2) of this section that a registered broker-dealer knows or has reason to know is a large trader." 17 C.F.R § 240.13h-1(a)(9).
[12] Adopting Release, *supra* note 3, at 46,976-77.
[13] The required records shall be kept for such periods of time as provided in § 240.17a-4(b).
[14] The term "reporting activity level" is defined as: (1) each transaction in NMS securities, effected in a single account during a calendar day, that is equal to or greater than 100 shares; (2) any transaction in NMS securities for fewer than 100 shares,

Reporting by broker-dealers will need to be submitted electronically to the SEC, no later than the day and time specified in the SEC's request, which generally will be no earlier that the business day following the date of the request.

*Monitoring:* Under Rule 13h-1, registered broker-dealers must treat as an Unidentified Large Trader, anyone that the broker-dealer "knows or has reason to know" is a large trader who has not complied with the Rule's identification requirements. However, the SEC has provided a safe harbor under Rule 13h-1, which generally states that a registered broker-dealer shall be considered to not know or have reason to know that a person is a large trader if the broker-dealer does not have actual knowledge that a person is a large trader, and has implemented written policies and procedures to identify any customers whose transactions at the broker-dealer equal or exceed the identifying activity level and, if so, treat such persons as Unidentified Large Traders and notify them of their potential reporting obligations under the Rule.[15]

## 5. Conclusion

Investment advisers and broker-dealers with discretionary authority over client assets may want to consider performing a review of trading activity over the last 12 to 24 months to determine whether they may fall under the definition of large trader, thus being required to make Form 13H filings. Should such firms determine that filings maybe necessary, the following additional steps should be considered:

(a) Implementing controls to capture aggregated transaction information going forward; and
(b) Establishing policies and procedures covering requirements and compliance with Rule 13h-1.

Broker-dealers that execute transactions for potential large traders should begin setting up a system to help ensure compliance with the recordkeeping, reporting and monitoring requirements of the rule by April 30, 2012, including adopting policies and procedures for identifying and notifying Unidentified Large Traders.

**For more information about this topic and other legal services, please contact us at (619) 298-2880, info@jackolg.com or visit www.jackolg.com. Thank you.**

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effected in a single account during a calendar day, that a registered broker-dealer may deem appropriate; or (3) such other amount that may be established by order of the Commission from time to time. 17 C.F.R § 240.13h-1(a)(8).

[15] Adopting Release, *supra* note 3, at 46,978-80.