



► Compliance Corner

— By Paul M. Miller and Keri E. Riemer*

Large Traders: A Review of Rule 13h-1 and Form 13H

In light of developments in trading technology and the resulting increased speed and volume at which securities transactions are effected, the SEC adopted a new rule designed to enhance its ability to oversee the U.S. securities markets and respond to market events. Rule 13h-1 under the Securities Exchange Act of 1934 requires entities with investment discretion, including investment advisers, that engage in a substantial amount of trading activity to identify themselves to the SEC as “large traders” by filing new Form 13H and to provide certain information to the broker-dealers through which the traders execute transactions.

This article discusses who qualifies as a large trader and how to comply with Rule 13h-1, including what information large traders must provide to the SEC when filing Form 13H.

Determining Large Trader Status

A “large trader” is any person that directly or indirectly, including through other persons controlled by such person, exercises investment discretion over one or more accounts and, on behalf of such accounts, effects through one or more registered broker-dealers transactions in NMS securities (*i.e.*, U.S. exchange-listed securities, including equities and options) in an aggregate amount equal to at least (i) two million shares or \$20 million during any single calendar day; or (ii) 20 million shares or \$200 million during any single calendar month. This definition, which is designed

to focus on the ultimate parent company of an entity or entities that employ or otherwise control the individuals that exercise investment discretion, integrates several key concepts: “control,” “investment discretion,” and “transaction.” These concepts, in addition to the qualifying transaction thresholds, serve as essential elements in determining a person’s status as a “large trader,” and the scope of the new rule’s application to such person.

Control

The rule defines “control” as having the power to direct the management and policies of an entity, and it incorporates a presumption of control when a person owns 25% or more of a class of an entity’s voting securities, or has the power to sell, or direct the sale of, 25% or more of a class of an entity’s voting securities. For example, a corporation that contributes 25% of an investment adviser’s capital would be presumed to control that adviser. In the event that the investment adviser qualified as a large trader, the corporation would likewise be deemed a large trader.

An entity seeking to determine whether its trading activity has reached the qualifying transaction thresholds must aggregate all of its transactions in NMS securities with those of its controlled entities. Accordingly, if an adviser wholly owns an investment management subsidiary, and that subsidiary exercises investment discretion and trades \$20 million in NMS securities during a calendar day, the adviser would be deemed

a large trader, even if it has not made a single trade.

Investment Discretion

The rule defines “investment discretion” by referencing the existing definition of the term under the Securities Exchange Act of 1934. In addition, the rule clarifies that a person’s employees who exercise investment discretion within the scope of their employment are deemed to exercise such discretion on behalf of the employing person. As a result, an entity that employs a natural person who individually satisfies the definition of a large trader would be deemed a large trader for purposes of the rule, and the employing entity would be subject to the rule’s requirements.

Transactions

In seeking to prevent certain small or infrequent traders, and traders that do not exercise investment discretion, from inadvertently being deemed large traders, the SEC has excluded a series of enumerated transactions from the calculation of the transaction threshold, including: any journal or bookkeeping entries made to an account to record the receipt or delivery of funds or securities pursuant to a transaction settlement; any transaction that is part of a securities offering by or on behalf of an issuer, or by an underwriter on behalf of an issuer (unless such offerings are effected through a national securities

Continued on page 17

exchange); any transaction that constitutes a gift; any transaction effected by a court-appointed executor, administrator, or fiduciary pursuant to the distribution of a decedent's estate, or any transaction effected pursuant to a court order or judgment; a transaction effected pursuant to a rollover of qualified plan or trust assets; any transaction between an employer and its employees effected pursuant to an award, allocation, sale, grant or exercise of an NMS security; and a transaction entered into to effect a business combination.

Complying with Rule 13h-1

Satisfying the Identification Requirements: File Initial Form 13H and Provide Broker-Dealer Disclosures

The SEC set December 1, 2011 as the compliance date for large traders to file Form 13H with the SEC. Any adviser that becomes a large trader after December 1, 2011 must file its initial Form 13H with the SEC through EDGAR within 10 days of first effecting transactions equal to one of the trading thresholds.

In completing Form 13H, the large trader must provide information related to its business, organizational structure, regulatory status, and governance. The adviser must also disclose information about certain SEC filings made by the adviser's affiliates, if any, and provide identifying and contact information for the broker-dealers with which the adviser has an account.

After receiving the adviser's initial Form 13H, the SEC will assign the adviser a large trader identification number, or "LTID." The adviser must disclose to the U.S.-registered broker-dealers effecting transactions on its behalf the LTID and the accounts to which the LTID applies. An adviser that has filed an initial Form 13H and obtained an LTID should monitor on a regular basis the existing U.S.-registered broker-dealers effecting transac-

tions on its behalf. In addition, to ensure that the LTID and an accurate list of all of the accounts to which it applies, are disclosed to broker-dealers as required, the adviser should consider appointing one person who will be responsible for maintaining and updating the list of broker-dealers and for updating records with respect to the dissemination of the LTID to the brokers.

Not all entities meeting the definition of "large trader" need to file Form 13H with the SEC. In the context of a large corporate complex, a parent company may file Form 13H on behalf of the entire complex. If an individual or subsidiary within a larger corporate group independently qualifies as a large trader, and the parent company identifies itself as the large trader on behalf of the entire group, then the individual or subsidiary would not have to separately identify itself. By identifying itself to the SEC and to broker-dealers as the large trader on behalf of the group, the parent company takes on the obligation to comply with the new requirements.

Likewise, a parent company may be relieved of the filing requirement if each entity controlled by that company complies with the identification obligations with respect to all of the controlling company's accounts. A controlling company may not, however, avoid the identification requirements if any one of its controlled accounts has not been identified to the SEC. In some cases, particularly with respect to a complex organization, it may be more efficient for the ultimate parent company to satisfy the identification requirements on behalf of its controlling entities and their respective accounts.

Some investment advisers that conduct substantial trading activity and have no subsidiaries may be able to determine with little analysis that they qualify as large traders subject to the identification requirements. In contrast, investment advisers that have fewer assets under management, conduct trades infrequently, or are subsidiaries within a

large corporate complex should consider implementing procedures and mechanisms designed to alert the adviser that its trading activities are approaching the qualifying trading thresholds for large trader status. Such mechanisms could, for example, track and aggregate trades, establish key triggers and notify personnel when certain thresholds are reached (*e.g.*, 18 million shares traded prior to the market's close during a single day). In addition, the CCO should monitor trading reports on a regular basis (*e.g.*, weekly), test the effectiveness of any triggers or alerts designed to notify traders that significant thresholds have been reached, and oversee the implementation of an employee training program covering the new rules. An adviser that is a subsidiary within a large corporate complex should request guidance from the parent company as to its identification or reporting obligations, if any.

Maintain Compliance with Identification Requirements: Amend and Update Form 13H

An adviser that is a large trader must annually update its Form 13H within 45 days of each calendar year end. In addition, in the event that any information contained in a filed Form 13H becomes inaccurate for any reason (*e.g.*, a change of regulatory status or broker-dealers used), the adviser must file an amended Form 13H no later than the end of the calendar quarter in which such information becomes inaccurate. An adviser that previously filed Form 13H may request "inactive status" if, during the previous full calendar year, it did not effect transactions equal to one of the trading thresholds.

An investment adviser that has filed its initial Form 13H and provided the appropriate broker-dealers with the LTID disclosures may want to focus its compliance efforts on tracking any events

Continued on page 18

that may require the adviser to make an amended filing. For example, any change in name, business address, or organizational chart would require the adviser to amend its Form 13H. To help ensure that the amended filing is submitted during the appropriate calendar quarter, the procedures should include a mechanism for recording the date that the information at issue became inaccurate.

Policies and Procedures

Investment advisers should update their policies and procedures for making regulatory filings to include procedures for making 13H filings on a timely basis, even if such advisers may not currently be large traders subject to the filing

requirements. Advisers should also implement procedures designed to ensure that the LTID disclosure requirements are satisfied.

Conclusion

The new rule is broad in scope and does not offer any explicit exclusions or exemptions from qualifying as a large trader. As a result, an adviser that—even infrequently—participates in the financial markets should review the rule and its trading activity to determine whether it qualifies as a large trader and is required to file Form 13H and satisfy the rule's other reporting and disclosure requirements.

* *Paul M. Miller is a partner in the Washington, DC office of Seward & Kissel LLP. He can be reached at millerp@sewkis.com or (202) 737-8833. Keri E. Riemer is an associate in the New York office of Seward & Kissel LLP. She can be reached at riemer@sewkis.com or (212) 574-1598. This article is intended to provide general information on the matters discussed. It should not be relied upon for legal advice on any matter. ■*



Paul Miller



Keri Riemer

Last 2011 IAA Fall Compliance Workshop: REGISTER NOW!

The Investment Adviser Association is pleased to offer one more 2011 Fall Compliance Workshop—in Boston. Topics will include: **Current Regulatory Developments for Advisers; New Amendments to Form ADV Part 1; Lessons Learned from New Form ADV Part 2; New SEC Whistleblower Rules; Insider Trading; Social Media; and Pay to Play Rule.** Speakers will include IAA legal staff and attorneys from nationally-recognized law firms. Each workshop will include a networking luncheon at which firms can share ideas about SEC exams and compliance testing protocols. After lunch, the SEC regional administrator will discuss current inspection priorities and issues for advisers.

The IAA workshops are an excellent opportunity to network with other compliance professionals and gain their insights on challenging legal and regulatory issues. The workshop is from 9:15am to 2:15pm.

TO REGISTER: Please log on to the IAA web site and go to Events. Registration fees are: IAA Members/First Registrant: \$300; IAA Members/Additional Registrants (same firm): \$150; and IAA Associate Member/Non-Member: \$500. For more information, please contact IAA Director of Meetings & Events, Lisa Gillette at (202) 293-4222 or lisa.gillette@investmentadviser.org.

Tuesday, December 6 • Boston

Omni Parker House Hotel
60 School St., Boston, MA 02108

Speakers: *Jason E. Brown, Ropes & Gray*
Chris Harvey, Dechert

The workshops are approved for Continuing Legal Education (CLE) in California, Georgia, Illinois, Texas, and pending in New York, and for continuing education credits for the NRS Investment Adviser Certified Compliance ProfessionalsSM (IACCPSM) designation.