

Commentary: The SEC Resurrects the Large Trader Reporting Rules

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This past week was STANY Week, when equity traders from the tri-State region mingled to socialize, network, and to hear about current issues affecting the community. So, it seems appropriate to discuss the proposed Large Trader Reporting rules, which were released by the SEC on April 14, 2010.

Large Trader Reporting rules are authorized by Section 13(h) of the Securities Exchange Act of 1934, which was added to the Exchange Act by the Market Reform Act of 1990. The Market Reform Act of 1990 was inspired by the collapse of the equity markets in 1987. Many of us now living can recall the Black Monday when worldwide equity markets began collapsing, an event that rendered the markets so dysfunctional that trades could not be executed at any price, producing the largest one-day stock market percentage decline in history. Nothing like the 1987 market collapse has ever happened in the equity markets since that time.

It took some time for the SEC to determine the cause of the 1987 market break. Eventually, the SEC determined that the collapse was caused by some well-timed antics in the market for securities futures by some traders at Salomon Brothers. The statute's authorization of Large Trader Reporting Rules was intended to provide the SEC with the tools needed to rapidly identify culprits causing market disruption in the future, and perhaps even to stop them before the cauldron came to full boil.

The current version of the Large Trader Reporting Rules is the SEC's third try. It initially proposed rules in 1991, which encountered massive industry opposition. The proposal was revised in 1994 and again met industry resistance. At the time, the primary complaint was that the Rules would be extremely costly to implement and that the costs could not be justified. The SEC never officially pulled the proposal, but it slipped off the regulatory agenda a few years later, never to return. Until now.

The "new" Rules actually are a further revision of the 1994 proposal, containing many of the same elements. As is the case with the earlier proposals, large traders are required to file a Form 13H, which would basically identify them, and obtain a Large Trader Identification Number (LTID). Larger traders would then provide the LTID to the broker-dealers maintaining their accounts. Broker-dealers would be

required to provide information to the SEC, upon request, about the trades conducted by a large trader. Reports would be required only for NMS stocks and options. As required by the statute, the information provided to the SEC would be kept confidential and would not be subject to Freedom of Information Act (FOIA) requests.

There are some revisions to the 1994 proposal. The old rule defined large traders by the accounts they owned or controlled, which could have required reports from persons who weren't necessarily responsible for the trading activity. The new Rules are more narrowly targeted to require reports only from persons who exercise investment discretion. The levels of activity that require reports are larger, and the Rules no longer automatically require reports from program trading, unless the quantity of trading produced by program would require reports. Broker-dealers that merely carry accounts, but do not execute trades, would not be required to keep books and records identifying large traders; the record-keeping obligation would only apply to executing broker-dealers. Finally, "large trader" is an aggregate concept under the new Rules, so if two or more large traders work for the same firm, only the firm is required to make reports. The SEC is also avoiding most of the criticism of earlier proposals by requiring broker-dealers to keep only records that already are maintained to produce Electronic Blue Sheets (EBS). The only additional required information would be the LTID and execution times.

An interesting argument against the new proposed Rules was authored by John Harris of BondMart Technologies in the article, "Large Trader Reporting System is Insulting, Unconstitutional," published by Tabb Forum on April 15, 2010. Mr. Harris argues that requiring larger traders to identify themselves violates the U.S. Constitution's Fourth Amendment protection against unreasonable searches and seizures: "Absent a valid search warrant based on probable cause and supported by oath or affirmation as required by law, the Commission has no more authority under the law to obtain and search such property than any other agency of government would have to search a person's home or other property without a warrant." The Fifth Amendment, Mr. Harris contends, is violated by the proposed rule because trading data is private property that the SEC is taking for public use without just compensation. If the SEC wants this data, "then it must purchase that data from willing sellers on the open market." It must be supposed that large traders would not be willing sellers at any price.

Like most lawyers, I always find constitutional arguments to be fun. Perhaps it's because we lawyers all dream of forever altering the law of the land through some brilliant pitch to the Supreme Court. Unfortunately, most of these fantasies never pass the straight-faced test—"Can I make this argument with a straight face?"—and I'm afraid Mr. Harris's creative legal arguments are no exception.

The SEC, as a Congressionally mandated agency, is entitled to assume that actions authorized by Congress are constitutional. Congress has indeed authorized the SEC to create Large Trader Reporting rules in Section 13(h) of the Exchange Act, so unless and until the federal courts decide that Congress violated the Constitution, the SEC is acting within its authority. As a general proposition, the federal courts, including the Supreme Court, are reluctant to declare a law enacted by popularly elected representatives to be unconstitutional. One of the reasons that striking down a law as unconstitutional is so newsworthy is that it doesn't happen very often.

However, we could speculate how the courts would react to Mr. Harris's Fourth and Fifth Amendment claims. The fact is that government agencies can't function without obtaining a lot of information about the activities they regulate. So, every regulatory agency imposes some sort of reporting by regulated persons, or is authorized to investigate and collect information from regulated persons. Broker-dealers, issuers, investment advisers and others are all required to register and provide information to the SEC. Broker-dealers, in particular, are now (and have been since the SEC began implementing the Exchange Act after its enactment in 1934) required to comply with very substantial record-keeping and reporting rules, and are subject to investigation and collection of even more information upon request by the SEC. Far from being required to pay for this information, the SEC usually collects fees from regulated persons to defray the costs of its regulatory review. It is hard to see how the federal courts would consider Section 13(h)'s fairly modest revision and amplification of this reporting system as a violation of liberties of constitutional dimensions.

Mr. Harris really is objecting to the activities of government agencies in general. And, from a constitutional perspective, that objection carries some water, since regulatory government agencies like the SEC didn't exist when the founders drafted the Constitution. However, that constitutional bridge was crossed many, many years ago.

While not contemplated by the founders, the fact is that regulatory agencies such as the SEC, all of them collecting information without paying for it and otherwise restricting the behavior of private citizens and private enterprise, do exist. Moreover, it is hard to imagine a world without them, since every modern industrial state has them. In countless ways, they are essential to satisfying the insistent demands of the citizenry that "somebody ought to do something" about any number of problems that arise from time to time. The lack of regulatory agencies, the infrastructure of modern government, is what the press popularly refers to as a "failed state"—one that has no ability to act to control the excesses and piratical instincts of a wholly unregulated citizenry. As a result, despite its expressed fondness for literal interpretation, I can't imagine even the current, conservative Supreme Court deciding that the administrative state is

unconstitutional. The Court has objected when government agencies sell information received by regulated entities or otherwise use it in ways that compete with them, but not when the information is used for bona fide regulatory purposes. They might agree with Mr. Harris that the activities of government agencies are, at times, insulting.

On the order of being careful what you wish for, it is worthwhile to consider how government functioned before regulatory agencies were created. In the nineteenth century, public policy, including industrial policy, essentially was executed by the courts. As they were called upon to redress public grievances by lawsuit, they sometimes ordered not just money damages, but changes in the way defendant corporations did their business. To get some idea of what that sort of thing looks like, in more recent history, the public school desegregation cases were administered by the federal courts in much the same manner. Judicial process is very cumbersome and lawyer intensive, making it an extraordinarily inefficient and expensive way to regulate private behavior. Reverting to that form of public administration would put our economy into the deep freeze.

If we all have to agree that the Constitution generally allows Congress to authorize the collection of information by public agencies, the real question we should ask about the new proposed Rules is whether they are good policy—is our government (in this case, the SEC) making rules that are necessary and reasonably designed to address some problem of public concern?

The 1987 collapse was an equity market collapse. It made sense to take the steps necessary to prevent another one. The SEC, and others, investigated the causes of the collapse and the SEC made lots of regulatory revisions at the time. Circuit breakers were imposed, exchanges were required to upgrade their systems, and the clearing process was upgraded and modernized. Since then, the SEC has taken a series of actions that encouraged electronic trading, culminating in Regulation NMS in 2006. As a result, the equity markets met the challenge of the recent Panic of 2008 without so much as a hiccup. Anyone who wanted to sell at any micro-second of the trading day found a willing buyer on the other side. The system worked perfectly. After this successful, real-world test of the equity markets, it seems clear that the proposed Rules are not necessary to accomplish market stabilization in the equity markets as Congress thought they were in 1990. The Large Trader Reporting Rules are a solution in search of a problem.

On the other hand, the debt markets had a heart attack in 2008. A lot of us would like to know more about the causes of that calamity, and at this very moment, the Financial Crisis Inquiry Commission is holding hearings and issuing subpoenas to get to the bottom of this. As the causes of the Panic of 2008 become known, we also would expect the SEC to focus on rulemaking to address this real and very scary problem with the debt markets. The recently proposed disclosure rules for

Asset-Backed Securities are a step in the right direction, but much, much more needs to be done to properly regulate the debt markets.

The SEC has been under a lot of pressure from a public demanding that it “do something” about the Panic of 2008. They have responded with a flurry of rule-making, much of which has no bearing on the real problem. Unnecessary rulemaking, though it may be constitutionally permitted, is not a good use of the taxpayers’ dollars. Unnecessary rulemaking wastes resources in producing and administering the unnecessary rules and, more importantly, diverts resources away from solving problems of much greater urgency. In the most basic sense, as Mr. Harris suggests, unnecessary rulemaking restricts our liberties without good cause, and has the potential to undermine our citizenry’s shared consent to be governed. In other words, regulatory restraint is the secret ingredient of the successful modern administrative state.