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AGENCY

US Securities and Exchange Commission (SEC)

Rule title
Large Trader Reporting

RIN	3235-AK55
Publication Date	October 3, 2011
Stage	Final

RULE SUMMARY

The rule requires large traders to identify themselves to the commission, and each receives a unique identification number that the trader must provide to broker-dealers. A "large trader" is a trader who transacts 2 million shares or shares with a market value of at least $20 million on any calendar day, or 20 million shares or $200 million in transactions in any calendar month. The identification number allows the commission to track that trader's transactions across multiple securities and broker-dealers. Parent companies of traders will be held responsible for determining if any of their traders fit this description and then must report to the SEC using a new form described in the rule. Large traders will receive an identification number, which they must report to broker-dealers, who then keep records of their trades. The SEC then reserves the right to request information on trades from broker-dealers.

COMMENTARY

The SEC promises that regulation and enforcement will be better once it has access to the data this regulation will require traders to report. But it does not explain how or what decisions it would make differently if it had access to analysis based on these data. Either the SEC is vague about the tangible benefits, or it believes they are so self-evident (at least to insiders) that no explanation is needed. It is unclear from reading this regulation how the SEC thinks this rule will improve citizens' quality of life. There is no discussion of a systemic problem that the agency is seeking to solve. For example, are markets too volatile right now? If so, relative to what? Have they become more volatile due to an increase in electronic trading in recent years? The May 2010 "flash crash" is mentioned several times, but this seems like anecdotal evidence rather than solid evidence that a persistent problem exists. The analysis calculates the regulation's paperwork and compliance burdens, but it does not examine alternatives. The analysis does not appear to have influenced decisions about the regulation.

This rule's economic analysis was scored by a team of economists as the basis for Jerry Ellig and Hester Peirce's study, "SEC Regulatory Analysis: 'A Long Way to Go and a Short Time to Get There.'"
For more information about Regulatory Report Cards issued by the Mercatus Center at George Mason University, see www.mercatus.org/reportcard.

OPENNESS	Score	Comments
1. How easily were the RIA, the proposed rule, and any supplementary materials found online?	5	1A
2. How verifiable are the data used in the analysis?	1	1B
3. How verifiable are the models and assumptions used in the analysis?	1	1C
4. Was the Regulatory Impact Analysis comprehensible to an informed layperson?	2	1D
Total Openness (Sum of 1–4)	9	

ANALYSIS	Score	Comments
5. How well does the analysis identify the desired outcomes and demonstrate that the regulation will achieve them?	0	2A
6. How well does the analysis identify and demonstrate the existence of a market failure or other systemic problem the regulation is supposed to solve?	1	2B
7. How well does the analysis assess the effectiveness of alternative approaches?	1	2C
8. How well does the analysis assess costs and benefits?	1	2D
Total Analysis (Sum of 5–8)	3	

USE	Score	Comments
9. Does the proposed rule or the RIA present evidence that the agency used the Regulatory Impact Analysis?	1	3A
10. Did the agency maximize net benefits or explain why it chose another alternative?	0	3B
11. Does the proposed rule establish measures and goals that can be used to track the regulation's results in the future?	0	3C
12. Did the agency indicate what data it will use to assess the regulation's performance in the future and establish provisions for doing so?	1	3D
Total Use (Sum of 9–12)	2	

Total Score	**14**	

This analysis was evaluated using the 2008–2012 scoring system, which evaluated regulatory analyses based on 12 criteria.
This analysis was scored on a scale from zero to 60 points.

OPENNESS			
Criterion	**Score**	Com. No.	Comment
1. How easily were the RIA, the proposed rule, and any supplementary materials found online?	5	1	RIN and keyword searches readily turn up the notice in regulations.gov. It is also readily accessible via the "regulations" link on the SEC homepage. The rule does not come up using the search function on the SEC website, however.
2. How verifiable are the data used in the analysis?	1	2	There was no real analysis done in this rule, although there were several examples of data being used. Data were used to estimate compliance costs and to estimate the number of entities that would be affected by this regulation. The commission said the estimate of number of entities affected was based on internal SEC data. This is not easily verifiable. Unfortunately, no data was used to estimate actual outcomes of the regulation.
3. How verifiable are the models and assumptions used in the analysis?	1	3	There is little in the way of a theory or model since the analysis is pretty sparse. A key assumption is that large traders account for significant volume and can move markets. Statistics showing that large traders account for significant volume are sourced to a CFTC/SEC staff report, a *Wall Street Journal* article, and blogs.
4. Was the analysis comprehensible to an informed layperson?	2	4	The analysis is not a difficult read, mainly because there is not much analysis. There are some gaps in the analysis. Essentially it says, "Regulation will be better if we have these data, so we're requiring them." There is no chain of logic linking more reporting to better outcomes. Cost calculations are a bit turgid but relatively clear.
ANALYSIS			
5. How well does the analysis identify the desired outcomes and demonstrate that the regulation will achieve them?	0		
Does the analysis clearly identify ultimate outcomes that affect citizens' quality of life?	1	5A	The primary "benefit" claimed is better commission administration and enforcement of the securities laws due to better understanding of the impact of large traders fueled by better data. The analysis mentions that investors should benefit since the SEC will have more access to information on large traders. How this will benefit them is not explained. Presumably, events like the "flash crash" will be easier to explain after the fact; however, whether the SEC believes these events are likely to occur less often due to this rule is never discussed. Better administration and enforcement are means to an end, not outcomes. The analysis asserts broadly that better regulation increases investor trust and capital formation.
Does the analysis identify how these outcomes are to be measured?	0	5B	Neither ultimate outcomes nor better data gathering are measured.
Does the analysis provide a coherent and testable theory showing how the regulation will produce the desired outcomes?	1	5C	The analysis describes reasons the Electronic Blue Sheet (EBS) system is inadequate to gather the data the SEC wants. But it does not outline how having these data will lead to specific positive outcomes. The analysis mentions that this rule will allow the agency to be able to investigate the nature of unusual market movements more quickly after they happen. Presumably, this will help prevent future volatile market movements, but this is not explained at all.

Does the analysis present credible empirical support for the theory?	0	5D	The analysis presents no empirical evidence that regulation would produce better outcomes if the SEC had these data.
Does the analysis adequately assess uncertainty about the outcomes?	0	5E	"Better regulation" is presented as a certainty.
6. How well does the analysis identify and demonstrate the existence of a market failure or other systemic problem the regulation is supposed to solve?	1		
Does the analysis identify a market failure or other systemic problem?	1	6A	Large investors can now trade in huge volumes at great speed. The SEC's current Electronic Blue Sheet (EBS) system does not allow it to easily track and aggregate a large number of trades by a single large trader across multiple securities on a next-day basis. In this sense, the SEC argues that the current data-gathering system is inadequate. Why this is suboptimal is not explained clearly, just asserted. The May 6, 2010, "flash crash" is mentioned several times, but this is only one event and could hardly be called a systemic problem. It is possible that markets have become more volatile in recent years, but this is not discussed, nor is there a connection made between market volatility and the activities of large traders.
Does the analysis outline a coherent and testable theory that explains why the problem (associated with the outcome above) is systemic rather than anecdotal?	2	6B	The EBS was not designed to track large traders' transactions in the way the SEC now believes is necessary. Large traders' activity is a significant and growing portion of market transactions. However, the analysis largely takes for granted that the SEC needs these data and that commission analysis of the data will produce some kind of benefit; this is assumed rather than explicitly explained. It is not clear if the commission presumes insider readers understand what it will do with the data, or if it lacks a clear idea. Since no real market failure is discussed, there is no theory to explain why a problem, if there is one, exists.
Does the analysis present credible empirical support for the theory?	1	6C	The primary evidence the commission needs the data is just a citation to the legislative history. The notice cites studies that indicate large traders account for a significant proportion of the market. It seems odd that the commission does not explain how it could have regulated differently in the past if it had been able to perform analysis using these data. The notice cites the rapid decline and recovery of prices on May 6, 2010, but does not really explain what the commission would have done differently if it had had the data.
Does the analysis adequately assess uncertainty about the existence or size of the problem?	0	6D	The vaguely defined problem is assumed to exist with certainty.
7. How well does the analysis assess the effectiveness of alternative approaches?	1		

Does the analysis enumerate other alternatives to address the problem?	1	7A	The analysis considers no alternatives to the regulation. The commission considered different lengths for the implementation period. It also considered requiring traders to supply their brokerage account numbers and to allow voluntary reporting. These were minor tweaks of the broader rule and not serious alternatives to the rule itself. The commission adopted several small modifications based on comments, such as requiring traders to identify their broker-dealers instead of requiring them to furnish account numbers, and allowing traders to register as large traders even if they had not yet reached the threshold.
Is the range of alternatives considered narrow (e.g., some exemptions to a regulation) or broad (e.g., performance-based regulation vs. command and control, market mechanisms, nonbinding guidance, information disclosure, addressing any government failures that caused the original problem)?	1	7B	The range is extremely narrow. Requiring large traders to report themselves to the SEC was always the core of the regulation. Several minor amendments to the rule were considered, but they would not change the rule substantially.
Does the analysis evaluate how alternative approaches would affect the amount of the outcome achieved?	0	7C	No alternatives were considered, and the analysis of the regulation did not specify or quantify outcomes.
Does the analysis adequately address the baseline? That is, what the state of the world is likely to be in the absence of federal intervention not just now but in the future?	1	7D	The baseline appears to be using the current EBS system to gather data, but since outcomes are not well specified or quantified, we have only the assertion that commission analysis and regulation would not be as good. The rule will expand the amount of data the commission gathers relative to now.
8. How well does the analysis assess costs and benefits?	1		
Does the analysis identify and quantify incremental costs of all alternatives considered?	2	8A	The commission says the primary costs are the trader's cost of self-identifying when it meets the threshold, the cost of filing the form, the cost of notifying broker-dealers, and broker-dealers' recordkeeping requirements. Only the compliance costs of the regulation are estimated, not costs of alternatives.
Does the analysis identify all expenditures likely to arise as a result of the regulation?	3	8B	The commission estimates the aggregate initial cost of filing the forms and notifying broker-dealers, the cost of filing amended (updated) forms, and the costs to broker-dealers.
Does the analysis identify how the regulation would likely affect the prices of goods and services?	0	8C	There is no discussion of how the rule might affect prices of securities or of trading services.
Does the analysis examine costs that stem from changes in human behavior as consumers and producers respond to the regulation?	2	8D	There is some discussion that the rule could encourage broker-dealers to implement policies requiring information on trades from all their customers, not just those deemed large traders. There is also concern that traders may be encouraged to trade through entities other than broker-dealers or to trade in foreign jurisdictions to avoid being impacted by the regulation. Some broker-dealers may also be driven offshore. The analysis asserts the costs would not have any effect on how traders conduct business, and would have no effect on competition, because the costs would be small.

If costs are uncertain, does the analysis present a range of estimates and/or perform a sensitivity analysis?	0	8E	The analysis notes some comments that suggest costs will be substantially higher. The commission dismisses these comments (which may suggest uncertainty about the SEC's estimates) on the grounds that the commenter may have above-average costs and that the figures used in the analysis are expected to be typical or average. In a few cases, the SEC revised its estimates, which are still presented as point estimates.
Does the analysis identify the alternative that maximizes net benefits?	0	8F	Benefits were not quantified, so net benefits were not calculated, and no alternatives were analyzed.
Does the analysis identify the cost-effectiveness of each alternative considered?	0	8G	Benefits were not quantified, so cost-effectiveness was not calculated, and no alternatives were analyzed.
Does the analysis identify all parties who would bear costs and assess the incidence of costs?	3	8H	Traders and broker-dealers are identified as bearing costs, and compliance costs are estimated. The analysis says there should be no effect on small entities because small entities are unlikely to qualify as large traders.
Does the analysis identify all parties who would receive benefits and assess the incidence of benefits?	1	8I	This is not addressed very clearly. The SEC implies the beneficiaries may be investors or the economy as a whole.
USE			
9. Does the proposed rule or the RIA present evidence that the agency used the analysis?	1	9	The analysis does not consider alternatives, and it appears to just calculate the compliance costs associated with the regulation. The cost-benefit analysis is mentioned several times in the notice.
10. Did the agency maximize net benefits or explain why it chose another alternative?	0	10	Benefits were not quantified and alternatives were not considered, so net benefits could not be compared.
11. Does the proposed rule establish measures and goals that can be used to track the regulation's results in the future?	0	11	There is no commitment to goals or measures. The analysis is not complete enough to develop them without further work.
12. Did the agency indicate what data it will use to assess the regulation's performance in the future and establish provisions for doing so?	1	12	Clearly, the agency will have access to data since the main purpose of the rule is to give the agency more data. There is no discussion of how this data will be used other than that it will be available to look back at unusual market activity. It would be fairly easy to track whether trading activity affects market volatility with the new information the SEC has access to.