

03-60 (KE)



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

April 23, 2003

Andre E. Owens, Esq.
Schiff Hardin & Waite
1101 Connecticut Ave., N.W.
Washington, D.C. 20036

Re: Rule 10a-1; Exemptive Relief under Short Sale Rule

Dear Mr. Owens:

In your letter dated April 17, 2003, as supplemented by telephone conversations with the staff, you request on behalf of ITG, Inc., a registered broker-dealer, an exemption from Rule 10a-1 under the Securities Exchange Act of 1934 ("Exchange Act") for transactions executed through ITG's Portfolio System for Institutional Trading ("POSIT").

We understand the facts to be as follows:

You state that POSIT is an alternative trading system that matches buying and selling interest among institutional investors and broker-dealers at various set times during the day. POSIT was designed to meet the special needs of institutional customers, including broker-dealers, who trade in terms of portfolios of stocks by providing an electronic order entry mechanism to facilitate trading in portfolios. POSIT also allows participants to enter single stock orders. Customers generally transmit their orders (which are unpriced) by means of electronic interfaces, or by telephone or facsimile to the ITG trading desk. Customer orders are not displayed and are matched confidentially by the computer in accordance with a predetermined algorithm. Regular Matches occur at random times during specific one-minute windows from 9:45 a.m. to 9:46 a.m.; 10:00 a.m. to 10:01 a.m.; 10:30 a.m. to 10:31 a.m.; 11:00 a.m. to 11:01 a.m.; 11:30 a.m. to 11:31 a.m.; 12:00 p.m. to 12:01 p.m.; 12:30 p.m. to 12:31 p.m.; 1:00 p.m. to 1:01 p.m.; 1:30 p.m. to 1:30 p.m.; 2:00 p.m. to 2:01 p.m.; 2:30 p.m. to 2:31 p.m.; 3:00 p.m. to 3:01 p.m. and 3:30 p.m. to 3:31 p.m.

All POSIT trades involving exchange-listed securities are priced and executed at the midpoint of the best bid and offer in the primary market for the security at the time of the match. This match will sometimes take place at a price that is below the last reported price for that security in the consolidated transaction reporting system. Absent an exemption, short sale orders executed in POSIT Regular Matches could result in violations of Rule 10a-1.¹

¹ POSIT previously received an exemption from Rule 10a-1 to operate under different matching

You believe that short sales executed through POSIT do not involve the types of abuses that Rule 10a-1 is designed to address. In support of this, you note that: all POSIT trades are processed on an anonymous basis and prices are fixed at the mid-point of the best bid and offer in the primary market for the security; there is no price discovery within POSIT because orders are not displayed and all trades occur in accordance with a predetermined algorithm;² and no participant can be assured of a match and no participant knows precisely when the match will occur. You also state that all short sale orders entered in POSIT will be appropriately marked in accordance with applicable rules. You also state that ITG will not conduct a match for a security that is the subject of a trading halt on the primary exchange at the time of the match. You further note that ITG, through its proprietary POSIT Watch System, monitors changes to bids and offers for stocks traded in POSIT to look for signs of manipulation. If ITG suspects that a subscriber has engaged in a manipulative activity through POSIT, ITG will report such activity to the NASD.

In view of the passive nature of pricing for the POSIT system, you have requested that the Commission grant an exemption from Rule 10a-1 for ITG's institutional customers, including broker-dealers, that execute short sale transactions through POSIT's Regular Matches.

Response:

Rule 3b-3 under the Exchange Act defines the term "short sale," and Rule 10a-1 governs short sales generally. Paragraph (a) of Rule 10a-1 covers transactions in any security registered on a national securities exchange, if trades in such security are reported pursuant to an "effective transaction reporting plan" ("Reported Securities"). A short sale of a Reported Security listed on a national securities exchange may not be effected at a price either: (1) below the last reported price of a transaction reported in the consolidated transaction reporting system ("minus tick"); or (2) at the last reported price if that price is lower than the last reported different price ("zero-minus tick").

Absent relief, trades effected in POSIT Regular Matches involving short sales of exchange-listed Reported Securities would have to comply with the "tick test" of paragraph (a) of Rule 10a-1. As described above, Regular Matches in POSIT occur at the mid-point of the inside bid and offer, which can result in short sales being effected at prices lower than the last reported sale price. Based on your representations, in particular, that POSIT Regular Matches will occur at an externally derived price within the existing

parameters. See Portfolio System for Institutional Trading (December 12, 1994) (1994 Exemption).

² ITG has represented that, within one year from the date of this exemption, POSIT will implement a fully automated system, which will eliminate use of a POSIT operator to manually start the match.

market and above the current best bid; there is no price discovery within POSIT because orders are not displayed and all trades occur in accordance with a predetermined algorithm; no participant can be assured of receiving a match; and the matches will occur on a random basis within each window so no participant knows precisely when the match will occur, the Division is of the view that POSIT trades would not appear to involve the types of abuses that Rule 10a-1 was designed to address.

Accordingly, on the basis of your representations and the facts presented, the Commission hereby grants, on a one-year pilot basis,³ an exemption from Rule 10a-1 to permit short sales effected during POSIT Regular Matches, as described above, without complying with the "tick" provisions of the rule, subject to the following conditions:

1. Persons relying on this exemption shall not be represented in the primary market offer or otherwise influence the primary market bid or offer at the time of the transaction; and
2. Transactions effected through POSIT shall not be made for the purpose of creating actual, or apparent, active trading in or depressing or otherwise manipulating the price of any security.
3. The exemption applies only to: exchange-listed Reported Securities that qualify as an "actively-traded security" under Regulation M or is one of the securities that comprise the S&P 500 Index;⁴ and where the exchange-listed Reported Security is *not* an "actively-traded security" or a S&P 500 Index security, the transaction is part of a basket transaction of 20 or more securities in which the subject security does not comprise more than 5% of the value of the basket traded.
4. During each one-minute window of a Regular Match, there will be no solicitation of orders from customers, nor will there be any communication to customers that the match has not yet occurred.
5. All short sale orders shall be marked as such.
6. ITG shall maintain and provide the Division of Market Regulation, upon

³ ITG will provide, six months from the date of this exemption, written records to the Division documenting the operation of the POSIT system. Prior to April 23, 2004 the Division will determine whether to extend this exemption.

⁴ 17 CFR 242.101(c)(1). Under Rule 101(c)(1) of Regulation M, actively-traded securities have an average daily trading volume (ADTV) value of at least \$1 million and are issued by an issuer with a public float value of at least \$150 million. For purposes of this letter, the ADTV shall be calculated in reference to the date on which the proposed POSIT match is to take place.

request, separately retrievable written records pertaining to: each short sale transaction effected in the POSIT Regular Matches, including the date, time, security, price, and size of each transaction; and the execution of each Regular Match, including the date and time of each Regular Match.

The foregoing exemption from Rule 10a-1(a) is based solely on your representations and the facts presented, and is strictly limited to the application of this rule to the proposed transactions and the operation of the POSIT system as described above. Such transactions should be discontinued, pending presentation of the facts for our consideration, in the event that any material change occurs with respect to any of those facts and representations. The exemption granted herein is subject to modification or revocation if at any time the Commission or the Division determines that such action is necessary or appropriate in furtherance of the purposes of the Exchange Act. This exemption supersedes the 1994 Exemption, and does not apply to transactions effected in the POSIT system prior to the date of this exemption.

In addition, your attention is directed to the anti-fraud and anti-manipulation provisions of the Exchange Act, particularly Sections 9(a) and 10(b), and Rule 10b-5 thereunder. Responsibility for compliance with these and any other applicable provisions of the federal securities laws must rest with ITG, Inc. and with participants effecting transactions on POSIT. This Division expresses no view with respect to any other questions that the proposed transactions may raise, including, but not limited to, the adequacy of the disclosure concerning, and the applicability of any federal or state laws to, the proposed transactions.

For the Commission, by the Division of Market
Regulation, pursuant to delegated authority,



Larry E. Bergmann
Senior Associate Director

April 17, 2003

VIA HAND DELIVERY

Mr. Larry E. Bergmann
Associate Director
Division of Market Regulation
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: Rule 10a-1; Exemptive Relief Under Short Sale Rule

Dear Mr. Bergmann:

On behalf of ITG Inc. ("ITG"), we hereby request that the Securities and Exchange Commission ("SEC" or "Commission") grant an exemption from Rule 10a-1 of the Securities Exchange Act of 1934, as amended ("Exchange Act"), pursuant to the Commission's authority under Rule 10a-1(f) of the Exchange Act, for certain transactions executed through ITG's Portfolio System for Institutional Trading ("POSIT") during regular trading hours (between 9:30 a.m. and 4:00 p.m. (ET)) that are priced at the midpoint of the best bid-asked quotation for the security, as described further below.¹ The requested relief would apply to short sale transactions effected in POSIT during regular trading hours involving exchange-listed securities that comprise the S&P 500 Index or that qualify as "actively-traded securities" under Regulation M. Where a security is not an S&P 500 Index security or an "actively-traded security," a proposed short sale transaction will be permitted only if it is conducted as part of a basket transaction of 20 or more securities in which the listed security does not comprise more than five percent of the value of the basket traded.

ITG is a broker-dealer registered with the Commission under Section 15 of the Exchange Act. ITG also is a member of the National Association of Securities Dealers ("NASD"). The

¹ The Commission originally granted an exemption for POSIT trades in 1994. See Portfolio System for Institutional Trading (publicly available December 12, 1994). The Commission also has granted exemptions from Rule 10a-1 for trades effected on POSIT after regular trading hours at New York Stock Exchange ("NYSE") and American Stock Exchange ("Amex") closing prices, and for trades effected on POSIT prior to the opening of regular trading hours that are priced on a volume-weighted average basis. See Jefferies and Company, Incorporated (publicly available December 31, 1991); Letter from Jamie Brigagliano, Assistant Director, SEC, to Andre E. Owens, Schiff Hardin & Waite (publicly available March 30, 2001). ITG will continue to comply with all of the conditions imposed by the Commission in connection with the granting of the exemptions for POSIT after-hours and pre-opening VWAP matches.

Mr. Larry E. Bergmann

April 17, 2003

Page 2

current request for exemptive relief is being sought in light of proposed changes in the operation of POSIT matches.²

I. Background

ITG operates POSIT, an alternative trading system that matches buying and selling interest among institutional investors and broker-dealers at various set times during the day. POSIT was designed to meet the special needs of institutional customers, including broker-dealers, who trade portfolios of stocks by providing an electronic order entry mechanism to facilitate trading in portfolios. POSIT also allows participants to enter single stock orders.

Matches currently are scheduled 14 times a day, with 13 matches conducted during regular trading hours ("Regular Matches") and one after-hours match.³ Regular Matches currently are conducted during one-minute windows from 9:45 a.m. to 9:46 a.m., 10:00 a.m. to 10:01 a.m., 10:30 a.m. to 10:31 a.m., 11:00 a.m. to 11:01 a.m., 11:30 a.m. to 11:31 a.m., 12:00 p.m. to 12:01 p.m., 12:30 p.m. to 12:31 p.m., 1:00 p.m. to 1:01 p.m., 1:30 p.m. to 1:31 p.m., 2:00 p.m. to 2:01 p.m., 2:30 p.m. to 2:31 p.m., 3:00 p.m. to 3:01 p.m. and 3:30 p.m. and 3:31 p.m.⁴ At the request of a client, ITG also uses POSIT to effect internal crosses of orders of the client ("Directed Crosses"). On a more limited basis, ITG conducts supplemental POSIT matches ("Supplemental Matches") when such matches are warranted by substantial levels of liquidity in the market.⁵

Clients may submit orders to POSIT via electronic interfaces, or by telephone or facsimile through the ITG trading desk. All orders entered in the system for execution during regular trading hours are confidential. Within each one-minute window, matches occur on a random basis.⁶ ITG personnel do not have discretion to delay a match and matches are delayed

² As discussed below, the primary changes in the operation of POSIT involve an increase in the number of POSIT matches and the proposed implementation of a one-minute window for conducting matches.

³ The after-hours match occurs after the close of regular trading. Orders are accepted for the after-hours match until 6:30 p.m., when a preliminary match is conducted. The after-hours match is finalized after 12:00 a.m. later that same evening. All trades involving exchange-listed securities executed in the after-hours match are priced at the prior 4:00 p.m. NYSE or Amex closing price, as applicable, and are reported to Nasdaq with the appropriate trade report modifier.

⁴ In the event that ITG wishes to institute any further Regular Matches or alter the timing of the matches, it will inform the SEC Staff prior to commencing such matches.

⁵ The requested exemptive relief would not apply to orders executed in Directed Crosses or Supplemental Matches. Instead, all transactions effected during Directed Crosses and Supplemental Matches in POSIT would have to comply with the requirements of Rule 10a-1.

⁶ To facilitate their ability to assist clients seeking to enter orders for a POSIT match, ITG personnel are notified 30 seconds prior to the start of each match window. The POSIT system also sends a randomly generated and confidential message to the POSIT operator within each one-minute window. The POSIT operator starts the match upon receipt of this message unless there are technical difficulties with the system.

Mr. Larry E. Bergmann

April 17, 2003

Page 3

only to the extent that there are technical difficulties with the system. ITG personnel may not solicit orders from clients or otherwise communicate to clients that a match has not yet occurred during a one-minute match window. All orders involving securities listed on an exchange that are matched by the system during the 13 Regular Matches are priced at the midpoint of the best bid and offer in the primary market for a security at the time of the match.

II. Exchange Act Rule 10a-1 and Need for Exemptive Relief

Rule 3b-3 under the Exchange Act defines the term "short sale" and Rule 10a-1 governs short sales generally. Under Rule 10a-1, a short sale of a security registered on a national securities exchange and reported in the consolidated reporting system may not be effected at a price either (1) below the last reported price of a transaction reported in such system ("minus tick") or (2) at the last reported price if such price is lower than the previously reported different price ("zero-minus tick").

Absent an exemption, orders executed in POSIT Regular Matches may violate Rule 10a-1 to the extent that the match price of a security subject to the short sale rule occurs on a minus tick or zero-minus tick with respect to the last sale in the consolidated transaction reporting system. For the reasons discussed below, and as recognized in the exemption previously granted by the Commission for executions occurring in POSIT during regular trading hours based on mid-point pricing, we do not believe that short sales executed through POSIT involve the types of abuses the short sale rule was designed to address.

III. Discussion

The genesis for the SEC's short sale rule lies in the 1929 stock market crash when many people blamed aggressive short selling for the crash and the market's prolonged inability to recover from the crash.⁸ In adopting Rule 10a-1, the SEC was concerned, among other things, about the use of short sales as a manipulation tool, such as a "bear raid" where short selling was argued to be used to drive down the price of a security by creating a sell-side imbalance.⁹ More recently, the purposes of the Rule 10a-1 have been described as to (i) allow relatively unrestricted short selling in an advancing market, (ii) prevent short selling at successively lower prices and (iii) prevent short sellers from exhausting all remaining bids at one price level.¹⁰

For Nasdaq securities, the execution price used for Regular Matches is the midpoint between the national best bid and offer at the time of the match. Matches of Nasdaq securities crossed during the after-hours matches are priced at the prior 4:00 p.m. primary Nasdaq closing price ("SuperMontage").

⁸ See 7 Louis Loss and Joel Seligman, *Securities Regulation* 3203-04, note 213 (3d ed. 1989, 1998).

⁹ See Exchange Act Release No. 42037, 64 F.R. 57,996 (Oct. 28, 1999).

¹⁰ *Id.* at 57997.

Mr. Larry E. Bergmann

April 17, 2003

Page 4

Thus, the key objectives of the SEC's short sale rule have been the prevention both of market destabilizing and manipulative activity.

We believe that trades executed in POSIT do not present risks to which the short sale rule is directed and request that the Commission exempt from Rule 10a-1 short sales effected in Regular Matches. As noted above, all orders sent to POSIT for execution in Regular Matches are confidential, and there is no assurance that an order submitted to the system will receive an execution in any given match cycle. Orders are unpriced as well, providing even less information to persons interested in engaging in abusive short sales. The system is periodic, making it particularly unlikely to be used to exert continuous downward pricing on securities subject to the short sale rule, and no client knows of the exact time of a POSIT match as all matches occur during the specified time windows. Given the growth in overall quotation traffic and the rapid degree to which quotations change in today's markets as a result of finer trading increments, we believe that a one-minute match window provides sufficient uncertainty regarding the exact time of a POSIT match. Moreover, because all securities matched by POSIT are executed at a derived price (for exchange-listed securities, the midpoint of the best bid and offer on the primary market for the security), the inside bid for a security subject to the rule will not be exhausted (and subsequently lowered) as a result of POSIT trades.¹¹ All short sale orders entered in POSIT will be appropriately marked in accordance with applicable rules, and ITG will not conduct a match for a security that is the subject of a trading halt on the primary exchange at the time of the match. We note that ITG, through its proprietary POSIT Watch system, monitors changes to bids and offers for stocks traded in POSIT to look for signs of manipulation. If ITG suspects that a subscriber has engaged in a manipulative activity through POSIT, ITG reports such activity to the NASD. ITG would continue this practice with respect to any suspicious trading behavior. Finally, all POSIT transactions are reported to Nasdaq by ITG in accordance with Nasdaq trade reporting rules.

In addition to the facts and representations above, ITG will continue to comply with all of the conditions imposed by the Commission in connection with the original grant of exemptions for POSIT Regular Matches.¹²

V. Conclusion

Based on the foregoing, we respectfully request that the Commission grant the requested relief from the requirements of Rule 10a-1 with respect to short sale transactions effected during

¹¹ As noted in the 1994 letter granting Rule 10a-1 relief, there is no price discovery in POSIT because all trades which result from an anonymous matching of buyer and seller interest occur in accordance with a predetermined algorithm.

¹² Specifically, ITG will continue to advise persons relying on this exemption that they may not be represented in the primary market offer or otherwise influence the primary market bid or offer at the time of the transaction. In addition, transactions effected on POSIT shall not be made for the purpose of creating actual, or apparent, active trading in or depressing or otherwise manipulating the price of any security.

Mr. Larry E. Bergmann
April 17, 2003
Page 5

POSIT Regular Matches involving exchange-listed securities that (1) comprise the S&P 500 Index, (2) qualify as "actively-traded securities" under Regulation M,¹³ or (3) are conducted as part of a basket transaction of 20 or more securities in which the listed security does not comprise more than five percent of the value of the basket traded.¹⁴

If you have any questions or require further information, please do not hesitate to call me at (202) 778-6400, or P. Mats Goebels, ITG's General Counsel, at (212) 588-4000. Thank you for your attention to this request.

Very truly yours,



Andre E. Owens

cc: P. Mats Goebels, Managing Director and General Counsel, ITG

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¹³ 17 CFR 242.101(c)(1). Under Rule 101(c)(1) of Regulation M, actively-traded securities must have an average daily trading volume ("ADTV") value of at least \$1 million and be issued by an issuer with a public float value of at least \$ 150 million. For purposes of this letter, the ADTV shall be calculated in reference to the date on which the proposed POSIT match is to take place.

¹⁴ ITG shall maintain and provide the Division of Market Regulation, upon request, separately retrievable written records pertaining to each exempt short sale transaction effected in POSIT Regular Matches, including the date, time, security, price and size of each transaction.