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ITG - Q2 2008 Investment Technology Group Earnings Conference Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen. And thank you for joining us to discuss ITG's second-quarter results for 2008. My name is Shantela and I will facilitate the call today. After the speakers' remarks there will be a question and answer period. I will provide further instructions before we take questions. As a reminder this call is being recorded.

I would like to turn the call over to ITG's Vice President of Investor Relations, Alicia Curran. Please proceed ma'am.

Alicia Curran - *Investment Technology Group, Inc. - VP, IR*

Good morning. In accordance with the Safe Harbor regulations, I would like to advise you that the forward-looking statements we will be making this morning are subject to a series of risks that may make actual results differ materially from expectations. I advise to you read about the risks in this morning's press release as well as in our SEC filings. I would also like to encourage to you visit the Investor Relations section of our website which contains the Powerpoint slides that accompany this presentation. To begin I would like to introduce ITG's CEO and President, Mr. Bob Gasser.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Good morning, and thank you for joining us to discuss ITG's second quarter. We are changing the format of the call a bit this quarter with all of my remarks in the beginning. I will highlight the key developments for the quarter and how they fit into the bigger picture in terms of current market trends and our strategic priorities. Howard will fill in the details of the quarter and we will move straight to the Q & A. It was a tough quarter in a difficult operating environment, but in my view, the two key takeaways are the impressive strength of our core US equities business and the underlying progress in our European operations.

Let's look first at the US. Average volumes in the US were 187 million shares for the quarter. This was a 2% decrease from the second quarter last year. NASDAQ volume was down 34% and New York Stock Exchange up 32% in the same period. Turning to US trends, fund managers have seen some recovery. In the first quarter equity mutual funds experienced a significant outflow of funds overall and declines in both domestic and international funds. In the most recent three-month period reported by ICI, there was a total positive inflow of about $19 billion with domestic and international equity funds back in positive territory. In terms of ITG's core US equities business, I have never been more confident about our competitive position in the US institutional space. We talked about how Triton is our flagship for penetrating new accounts. What we are seeing in the US market today is Triton is becoming a more powerful competitive advantage day by day. We are picking up new Triton clients of all kinds in terms of investment style and size.

In addition, Triton is penetrating deeper into existing clients as they broaden their usage from portfolio trading to single stocks. What I feel especially good about is that our competitive gains are coming against the specialty software and systems providers, as well as against the bulge bracket firms. You can see that trend in the latest independent market surveys.

In the Waters annual survey that was released introduced earlier this month investors voted ITG as having the number one execution management system in the industry. In Waters' words,"ITG's Triton and Radical systems have now been crowned as the best in the EMS business. ITG has a steadfast hold on the EMS market."

In the Waters survey, ITG broke into the top three for the first time as best broker overall alongside Goldman Sachs. ITG Net ranked in the top three financial networks in the industry. While a small part of the pie for us overall, ITG Net is establishing a formidable global footprint and a growing source of recurring, profitable revenue.

Institutions surveyed by Greenwich in Q1 2008 gave ITG high ratings as well. ITG was ranked number one electronic broker in the US for the third consecutive year. We scored a strong number one in our core base of investment managers. And we scored well in two areas we had been targeting for increased penetration. We ranked highly with mutual funds behind Credit Suisse. And we also ranked highly with hedge funds, an impressive performance against leader Goldman Sachs. ITG also ranked number one with hedge funds in terms of domestic agency portfolio trading.

You see the same pattern in algorithmic trading, where the buy-side ranked ITG number two ahead of Merrill, Goldman, Lehman, UBS, Citi and Morgan Stanley. And we are ranked number one for best dark pool liquidity sourcing algorithms and best pre- and post- trade analysis for algorithm trades.

Just one more citation from the Greenwich survey - institutions ranked ITG number one in equity crossing networks or dark pools. They ranked ITG number one across commission size, type of institution, and geographic region. A clean sweep of the category. I want to emphasize that POSIT is becoming a distinct standout in a crowded dark ATS space. It is important to separate and distinguish the business models that currently exist in the dark space. There are multi-lateral broker utilities such as BIDS, Level, and Millennium that are executing at utility rates. There are broker dealer internalization engines such as CSFB's Crossfinder and Goldman Sachs' Sigma X. There are exchanges that provide non-displayed order types that are integrated into their offerings. There are, however, only two institutional ATSs providing block liquidity, POSIT and Liquidnet. What distinguishes our model from all the others? Average execution size and the positive effects it has on the execution outcome.

These achievements speak volumes in terms of the competitive strength of our independent agency model versus the bulge bracket firms. The Greenwich survey clearly validates the value our clients' place on an integrated product sweep provided across the trading continuum. ITG has the leading technology, the broadest offerings across the continuum, a resilient infrastructure and the independence that the buy-side demands in this rapidly growing sector. It is these ringing endorsements from sophisticated institutions that assures us that our competitive position and growth prospects in our core US equities business are truly sustainable against all categories of competition.

ITG's core US equities business is more competitive than it has ever been and is moving forward with strong momentum. Our major competitors continue to suffer the effects of the US credit crisis, reduced trading capital, lack of re-investment, and multiple reductions in force across client facing teams industry wide. We are seeing more and more high-quality resumes crossing our desk. The current environment gives us an opportunity to increase our penetration in algos, crossing, DMA, and even pre-trade analytics. A key question for us and other firms is will this period wean asset managers from their more traditional ways of doing business permanently.

For ITG electronic trading is our core and only business. We have maintained unwavering support to our clients throughout these challenging markets. I am certain that the buy-side attaches a value to this focus and the strong continuity of our business will continue to make a difference in their choice of ITG as a strategic partner.

Turning for a moment to our crossing business, POSIT average daily volume was 45 million shares for the quarter. We believe we maintained a good amount of volume in crossing considering the overall market environment in institutional equities.

This morning we announced that we are buying back our interest in BLOCKalert and renaming it POSIT Alert. POSIT is one of the strongest bands in the space and we believe that the POSIT Alert name will strengthen the suite's identity among clients looking to access block liquidity. The primary differentiator for crossing systems is their ability to provide access to buy-side to buy-side block liquidity, which does not require sell-side partner. We believe the best asset we can leverage to increase block liquidity is our independence and trusted agency status.

BLOCKalert average daily volume was 10.4 million shares in the first half of the year, with an average execution size of 41,000 shares. We expect to maintain and grow the volume in BLOCKalert once ITG takes full ownership of the joint venture which has been re-named POSIT Alert. Our approach is the same as our approach to sell-side and POSIT. Sell-side order flow does not promote block liquidity.

Just one final note here on the US. Our average US rate card for the first half of 2008 is 86 mills which is 5% below our average rate card for the same period in 2007. Needless to say, our previous guidance for the 2008 rate card is proving to be conservative. That said, going forward, we have decided to stop providing guidance on future pricing expectations. For the past several years, the trend was a reliable indicator. Historically we believe guidance served a useful purpose. As our business grows, the variables supporting these estimates have become more and more difficult to predict. The trend is not as predictable now and so we do not think it is useful to provide guidance. We believe we were one of the only companies in the sector providing this information, so this brings us into line with common practice.

Let's turn now to international. In Canada, the TSX was down 5% sequentially as that global market's pulled back a bit. In addition, we saw competition from US firms that had not historically been very active north of the border. It could be that the weaknesses in their US operations led them to grab volume wherever they could find it. Whether this is a temporary phenomena or a permanent increase in competition, we will have to see. I am pleased, however, with ITG Canada's ability to grow its pre-tax operating contribution.

In Asia-Pac, overall results were slightly down. As you are aware the Asian markets were hit alongside major global markets with the Hang Seng index down over 4% sequentially. The weakness in Asia was partially offset by a strong performance in Australia. Throughout the region, we continued to make progress establishing our place on clients' desktops. Transaction costs analysis has been an effective calling card.

In Europe, as in the US, the equity markets have declined as a result of the credit crisis and its impact on the economic outlook. The difference is that commissions in the US are based on share volumes, which have been relatively strong. Whereas in Europe commissions are based on the value of the trade which means commissions decrease along with share prices.

The MSCI Pan-Euro index declined 5% during the quarter. Yet the important thing to note is that despite the market downturn, we were able to grow our revenues slightly from prior quarter levels. This is a tremendous accomplishment in an extremely competitive environment. Anecdotally, our top clients have told us that while in some cases the commission pool they are paying to sell-side brokers is down almost 50% year-over-year, the commissions they pay to us have remained stable. Thus, clients are becoming more aware of the value of our offering in this environment and we are still able to gain ground competitively. Our share of LSE customer volume was 4.4%, which was actually up from 3.6% in the prior quarter.

We continue to make competitive gains in Europe. That said, the investments we have been making are essential and position us for future growth. The trade-off is some margin impact when the market slows down. This leverage works both ways.

In the second quarter, however, the increased expenses were primarily related to variable costs. Each quarter our margins can be affected by several factors, including average trade size, number of tickets, and which regional stocks our clients are trading. Some of these factors were not as favorable for us as they were in the first quarter.

I am just back from Dublin last week where I met with our European management team. I am confident that we are well positioned to take advantage of coming fragmentation, fine tuning our market data expense management, and thoughtfully addressing the clearing and settlement challenges. The good news is that the pressure to lower costs in these areas will increase as new entrants to the market such as BATS and the recently announced execution clearing initiatives present alternatives.

Looking more closely at the European environment, our view is that the market decline is cyclical and that our secular growth program there is on track.

The cyclical effect will mitigate for several reasons. First is that at some point the economic uncertainty will eventually work its way through the system. As European share prices bottom out and begin to recover, that should have a positive impact in terms of our ad valorem revenue and in terms of upside operating leverage on our profits.

Secondly, the growth in electronic trading we are counting on in Europe is coming. Electronic trading increases the market for our services but it also provides potential to lower the costs of trading. In the UK, the success of Chi-X and the pending arrival of Turquoise, Nasdaq OMX and BATS shows the market is ready for alternative venues and that fragmentation has begun. As soon as the multi-lateral trading facilities, or MTFs as they are called, launch, we will start sending order flow to these lower cost venues. This will benefit us on a variety of levels.

First, as people get more familiar with alternative venues they will be more dependent on smart routing and dark aggregation, a category of algos where we are the leader according to Greenwich. This provides us with more and more liquidity in POSIT and resulting in crossing opportunities. Second, we can sell our algos as a way to reaggregate liquidity, and third we are optimistic that the arrival of additional low cost execution destinations will ultimately draw down execution costs across all of Europe. Lastly, with market data rivals such as Project Boat, we see a light at the end of the tunnel when it comes to our fixed expense base. Even on the clearing front, competition is blossoming with DTTC's Euroclear subsidiary already making waves by lowering fees. Granted the rest of Europe has a ways to go, but it is a start.

Last year, the European buy-side executed 28% of its trading through low-touch systems. This is well below the 65% rate seen here in the US, but European usage of low touch systems is steadily increasing. It is expected to hit 36% next year and 40% in 2010.

There are regional differences within Europe. In the UK, the buy-side uses direct market access systems in algorithms for 24% of its trading. That's almost twice as high for continental Western Europe. But surveys with Western European institutions show they plan to catch up within two years.

The shift of crossing networks in Europe has already begun. The UK buy-side uses them for 6% of their trading at this point and continental Europe for only 1%.

But it does look like the foundation is being put in place for rapid crossing growth in coming years. In the UK, the proportion of buy-side firms connected to crossing networks increased from 55% last year to 78% this year. In Western Europe, crossing connections increased from 25% last year to 33% this year. These growing connections are reflected in the TABB Group's projection of 46% compound annual growth in value traded on European crossing networks over the next two years.

And it looks like ITG is well positioned to benefit as crossing grows in Europe. The latest TABB report released in June shows that ITG is the number one crossing system to which the European buy side is connected.

Our TCA and other analytics are also well positioned for growth in Europe. A key objective of MiFID is to change the way that institutions define and achieve best execution. Yet the latest surveys show that so far only one quarter of European institutions have adopted new ways to measure best execution in response to MiFID. Many are still using internal spreadsheets, comparing their trades to prices displayed on a Bloomberg screen. As the remaining three quarters modernize their systems to comply with MiFID, it should be a great opportunity for the kinds of transaction cost analytics that ITG provides.

From a competitive perspective the most important trend is that we are continuing to expand on the penetration of the European desktop with Triton. Our open architecture and broker neutral positioning means it takes a while to impact our own numbers. But they are potent themes with European institutions and gaining control of their desktop is key to eventually controlling liquidity and getting our share of their business.

So short term, things will continue to be bumpy in Europe until they cycle through the current economic turmoil, but on the upside of this cycle and for the long term, ITG is positioned very well.

To wrap up, we faced many challenges this quarter. But overall we believe that it was a solid performance in our core US equities business, and that our business in Europe, which is the core of our International expansion, remains well positioned to benefit from the growth in electronic trading that is emerging there. For the longer term, we continue to build on those two cores by adding new asset classes and establishing platforms for growth in other regions around the world that mirror our clients' geographic mix. As always, we will watch the markets carefully to determine the appropriate pace of investment. We believe that we must continue to invest in the global market to position ourselves for the turn around in the markets. This is not the time to retrench or pull back. But we will be prudent about our plans and watch our expenses carefully. With that top-down overview, Howard will now provide you additional detail behind the second-quarter results and then we will both take your questions.

Howard Naphtali - *Investment Technology Group, Inc. - CFO*

Thank you, Bob. This was a solid quarter for ITG in a weak business environment as the strength of our business model, particularly in the US and Canada produced good earnings and strong cash flow. As noted on slide four, we generated revenues of $180 million and earnings per share of $0.58, which was a good performance in the second-quarter business conditions and, due to our outstanding first-quarter results, have generated revenue growth of 12% with a related 15% increase in earnings per share to $1.33 for the year to date.

Moving to the consolidated results on slide five, our US business produced solid results and generated $0.55 of earnings, a 6% growth over last year. While our International businesses were weaker in this market environment that saw significant declines in turnover in most International markets. Given our continuing investment in Europe and Asia, we generated International earnings per share of $0.03 versus $0.08 last year to yield consolidated earnings per share of $0.58. For future modeling purposes, it should be noted that our consolidated Other Income line has included $800,000 to $900,000 per quarter in service fee revenue from BLOCKalert. Due to the deal we announced this morning, these revenues will be eliminated as of August 1st, so you should reduce your estimates for Other Income accordingly. However, the bottom line effect will not be significant.

Per slide six, for the year-to-date, our US operations earned $1.24 per share, a 20% growth over 2007, while our International earnings pulled back from prior year levels to $0.09 per share. This yielded a consolidated earnings per share of $1.33.

Moving to slide seven, consolidated expenses were $136.3 million, an $8.9 million decrease versus the trailing quarter as we have been carefully holding the line on all discretionary costs in this market environment. Overall, our US cost declined $8.8 million versus the first quarter while international expenses declined $100,000. Variances in the major cost categories were as follows:

Compensation costs decreased $9.1 million, driven principally by lower incentive compensation due to the lower earnings level versus both prior year and trailing quarter. Our US compensation rate was 32.1% of revenues which is relatively consistent with the last several quarters. International compensation costs decreased $1.4 million with costs decreasing in both Canada and Europe due to the decline in pre-tax earnings, while there was a small increase in Asia due to headcount growth as previously discussed with you. Our full-time global headcount was 1,286 at the end of the quarter.

Transaction processing costs were unchanged for the quarter, as a $1.1 million reduction in US costs was offset by an almost identical cost increase in Europe. Although European revenues were virtually unchanged from the first quarter, we saw a significant increase in Continental European business which now comprises almost 70% of commission revenues for the second quarter and helped drive the related increase in transaction processing cost from 39% of revenues in the first quarter to 45% of revenues in the current quarter. As new execution venues become available, we will begin utilizing our smart router technology to drive down execution costs in the same manner as we have in the United States.

And in the US, only in large part to this execution cost reduction, transaction processing costs represented 7.9% of revenues in the second quarter versus 10.3% last year and 7.4% in the trailing quarter, which also had the benefit of a DTC and NSCC rebate. These costs were actually 8.3% of revenues in the first quarter, excluding this rebate.

Occupancy, telecommunications and other G&A costs were, collectively, only $200,000 greater than the previous quarter. The related US costs were well within the guidance ranges we had previously provided to you with US occupancy and Equipment costs being the only area that experienced significant growth versus the first quarter and these came in at $11.2 million or slightly above the mid-point of our guidance range.

On our International financial summary slide, you can see the breakdown of the $48.7 million of non-US revenues for the quarter. Although we grew year-over-year revenues by $6.6 million versus the second quarter of 2007, we experienced a small $1.2 million revenue decline versus the first quarter of this year.

On a pre-tax basis, our combined Asia-Pacific region fell back $.5 million loss as Australia lost $400,000 on $3.5 million of revenues. Hong Kong had a challenging quarter with $5.1 million of revenues and $400,000 of pre-tax profits, while our Japanese loss was $.5 million for the quarter. We still remain at the early stages of the evolution of our Asia-Pacific business and continue to make good progress on product placements on customer trading desks as Bob described earlier. In Europe, our revenues were flat sequentially, and cost growth was virtually all related to transaction processing as previously discussed. Canadian revenues were a solid $19.8 million with pre-tax margins holding at 30.7%, unchanged from the first quarter and pre-tax profits were $6.1 million.

On slide nine, we track our Canadian, European, and Asia-Pacific performance over the past year.

Although we saw a small reduction in Canadian revenues this quarter, as I just indicated, our pre-tax profit margins continued above 30% for the quarter as the earnings leverage in the ITG electronic trading business model as it evolves in Canada is being confirmed by our performance.

In contrast to the consistent margin performance in Canada, this was a challenging quarter for Europe and Asia-Pacific where combined revenues were approximately $700,000 greater than the trailing quarter, which is a good performance in difficult market conditions. In local currency terms, European revenues were GBP 10.4 million with pre-tax income of GBP 800,000.

We continue to invest with a long-term view in Europe and Asia -- in the European and Asia-Pacific markets, excuse me, to gain desktop presence for our key Triton and Algo products and absorbed a $2.1 million pre-tax loss for the quarter, after considering both our significant development costs in Israel and the Asia-Pacific pre-tax loss of $.5 million.

Moving to slide 10, the blended average commissions per share from broker dealer revenues achieved during the quarter was 83 mills, 6% decline from the 88 mills in the proceeding quarter and a 7% reduction from from the 89 mills in the second quarter last year.

As you can also see from this slide, our OMS commission revenues held steady at $4.7 million for the quarter and we generated $5 million of commission revenues from ITG Derivatives in its third complete quarter as a subsidiary of ITG. The loss for the derivatives business in the second quarter was $300,000 pre-tax.

On slide 11, you can see that our pre-tax margins during the quarter were 24.4% for ITG as a whole, while holding at 30.4% for our US business. The drivers to our maintaining US margins above 30% for the quarter were the reduction in variable compensation due to reduced revenues and pre-tax earnings, together with the savings achieved in transaction processing costs over the past year deriving from both our move to self-clearing in May of 2007 and the value provided by our smart router technology in driving down execution costs. The decrease in these US transaction process and costs from 10.3% to 7.9% of revenues as previously described speaks for itself. Our US margin sensitivity analysis suggests that US pre-tax margins for the remainder two quarters of 2008 may range from 28% to 34% with the variability dependent principally upon revenue levels that may be achieved under various market scenarios.

On slide 12 we see that diluted earnings per share for the second quarter were $0.58.

Our effective consolidated income tax rate for the second quarter was 41.6% compared to 41.5% in the second quarter of '07 and consistent with our guidance levels that our effective tax rate would typically be in the 41% to 41.5% range.

Moving briefly to our balance sheet, we had approximately $291 million of unrestricted cash at June 30. However, unrestricted cash should not be confused with excess cash. We are continuing to deploy over $120 million for subsidiaries outside of the United States. And as we previously advised you, we require approximately $100 million to operate our US businesses. Furthermore, since we are self-clearing in the US, there are varying funding requirements with the NSCC. The required amount fluctuates day to day, and was as high as $121 million at one point this year. During the second quarter, we repurchased 243,000 shares of stock at an average price of $37.80 and are poised to use excess cash opportunistically to repurchase shares.

With that, I will turn it back to our CEO, Bob Gasser, for a final comment before we move to Q&A.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Thanks, Howard. To conclude, many of you believe as we do that our stock does not accurately reflect the growth prospects for our business. Yesterday, our board approved a two million share repurchase authorization. After repurchasing $9 million worth of stock in 2Q, this gives us approximately 2.5 million shares when combined with our original authorization.

Finally, I want to thank my colleagues for their continued commitment to ITG and its mission. While the environment has been a difficult one, they have, as always, risen to the occasion. With that, we will take your questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS) Questions will be taken in the order received. (OPERATOR INSTRUCTIONS) And your first question comes from the line of Mr. Ken Worthington of JPMorgan. Please proceed, sir.

Ken Worthington - *JPMorgan - Analyst*

Hi, good morning. I have a series of questions on BLOCKalert. I am just going to fire them off.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Okay.

Ken Worthington - *JPMorgan - Analyst*

How did the purchase come about? Did Merrill approach you or did you approach Merrill?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

I think there was a consensus amongst the two of us that it was probably a good idea to resolve the partnership. We have been at this for the last two and a half years. As you are aware, Ken, market structure has changed dramatically. I think the way that firms think about their liquidity in a proprietary way internally has changed quite a bit, and I think we found after two and a half years that maybe our view or our vision for this business was not aligned. We have a tremendous amount of respect for Merrill Lynch and for the management team there. But I think we found that going forward, it would be best if we went in separate directions.

Ken Worthington - *JPMorgan - Analyst*

So are there changes to the product or service that you are going to make when Merrill is out of the picture?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

No, not anything material. We have assimilated the folks that were a part of BLOCKalert into our operation. The distribution that we have in terms of the integration remains as is. We are going to be obviously rebranding and changing some signage et al, but there is no real material change there. It will proceed as the same going concerned for all intents and purposes.

Ken Worthington - *JPMorgan - Analyst*

Was BLOCKalert making money?

Howard Naphtali - *Investment Technology Group, Inc. - CFO*

No.

Ken Worthington - *JPMorgan - Analyst*

Okay. And will you bring in another partner or are you -- have you contemplated bringing in another partner?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

I think at this stage of the game, Ken, in the US and in Europe and in Australia where we are currently in production, I think it is safe to assume that we've decide it is best to go it alone.

Ken Worthington - *JPMorgan - Analyst*

Okay. And then - you guys report monthly trading volumes. Does the purchase of BLOCKalert impact those trading volumes that you report monthly? In other words --

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Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

It does not in any way.

Ken Worthington - *JPMorgan - Analyst*

Not in any way. Okay. Perfect. Thank you. I will requeue up for my other questions if they are not asked. Thanks.

Operator

And your next question comes from the line of Niamh Alexander of KBW. Please proceed.

Niamh Alexander - *KBW - Analyst*

Hi. Thanks for taking my questions. And Bob, can I just go back to your comment on the share repurchase authorization. I just wanted to get some clarification here. It has been increased to 2.5 million so an additional two added?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Right.

Niamh Alexander - *KBW - Analyst*

And then -- sorry, was that a yes?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Yes.

Niamh Alexander - *KBW - Analyst*

Okay, great, thanks. Maybe help me understand yourself and timing. Would last quarter's level of 240,000 odd shares be a guide or should we think of the pace of the second half of last year?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

I don't know that I am in a position to give you any specific guidance, Niamh, in terms of the timing here, but suffice to say we will be, as Howard alluded to in his comments, opportunistic. And I think that probably comes as bit of a surprise that we did repurchase some shares in Q2 which is reflective, I think, of ours and the board's view that our stock is good value at these levels. As we look at how we're going to deploy capital going forward; the stock is at the top of the list without a doubt.

Niamh Alexander - *KBW - Analyst*

Okay. That's very helpful. Thank you for sharing that, Bob. Sorry I missed the beginning of the call. Did you disclose July's volumes? I heard you talk about mutual flows positive, and that is your core customer group.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

We did not, Niamh.

Niamh Alexander - *KBW - Analyst*

Okay. Can you share that with us?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

We will not share it on this call. We will share it in its normal cycle which is next Friday, I believe. But going forward I think what we have decided to do was to separate those announcements with the exception of anything we would consider a negative surprise or negative -- or something that would be interpreted as negative.

Niamh Alexander - *KBW - Analyst*

Okay. That's great. Thanks for clarifying that. That is helpful actually. Thank you. And then I guess on the rate card, just to understand. Is the rate card you are not going to disclose or is it just guidance on the rate card that you're not?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

It's guidance.

Niamh Alexander - *KBW - Analyst*

Just guidance that you are not going to disclose any more going forward. Okay, that's great. Thanks. Lastly, there has been -- we have been hearing more about the large brokers, dark pools in the industry. For example, Goldman Sigma X seems to really be ratcheting up its volume. And above that of POSIT, above that of Liquidnet. Do you have you any sense of the average block size, kind of for the brokers, is that still substantially below POSIT and Liquidnet's average block size?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

From everything I've seen - and that is from independent sources and anecdotally - the internalization engines at the brokers are operating at a significant fraction of our block size liquidity.

Niamh Alexander - *KBW - Analyst*

Okay.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

So they look more like a multilateral dark ECN or an exchange even from the perspective of average execution size and that's really -- I thought it was really important to stress that in today's comments is the differentiation amongst the dark pool models. And we don't have the ability within POSIT -- within the POSIT suite to manufacture anything. We can't manufacture with capital, we can't manufacture it with proprietary trading, we can't manufacture it with anything other than good old natural liquidity between institutions.

Niamh Alexander - *KBW - Analyst*

Okay. That is helpful, thanks. And then on the same subject of the brokers. I am seeing that one of the brokers is kind of appealing to regulators to kind of force some of the dark pools to open up to all brokers. Is that something that you might think might actually take effect, or have you kind of gotten involved with that discussion?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

You can rest assured that we are watching that development very closely. And could not at this stage of the game disagree more with that -- with that point of view.

Niamh Alexander - *KBW - Analyst*

Okay. That's great. Thank you for taking my questions, Bob.

Operator

Your next question comes from the line of Mr. Mike Vinciquerra of BMO Capital Markets. Please proceed.

Mike Vinciquerra - *BMO Capital Markets - Analyst*

Good morning.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Hey, Mike, good morning.

Mike Vinciquerra - *BMO Capital Markets - Analyst*

One more question on the block side. Is there any order flow coming from Merrill's own clients? In other words, any potential loss of revenue when you dissolve this?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

It is pretty immaterial, Mike.

Mike Vinciquerra - *BMO Capital Markets - Analyst*

Okay. That being the case, Howard, could you step through a little more detail. You gave a little bit of the financial impact, $800,000 to $900,000 in the other income line. But in terms of -- you said it was a minimal impact overall. What other line items in the income statement are going to be impacted by this?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Well, it's really going through other G&A because it was an equity investment of a 50% ownership in a joint venture, which meant we picked up 50% of the losses of BLOCKalert as an equity pickup and that was included in the other G&A line item. So that loss pickup will disappear as will the $800,000 to $900,000 that was sitting the other income line and more or less they were close to a wash from quarter to quarter. The delta was about $100,000 which I said it was insignificant.

Mike Vinciquerra - *BMO Capital Markets - Analyst*

That is helpful. Thank you. Shifting to the Derivatives business. When I look at the numbers and I don't know if it is accurate at this point to start looking at you guys on the -- versus the market itself, but the market was down, we have about 4% in terms of total contracts. ITG down about 15%. Can you talk about what is going -- the 15% in terms of your commissions. But can you talk about what is going on there in terms of gaining share of your equity clients now using you for derivatives and so forth? How is the progress there in terms of gaining new clients?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

I think the institutional activity has mirrored what we saw in terms of April and May, so I think it was kind of a very similar trend to the one we saw in the cash equities business. I think going forward we continue to feel very confident about our ability to integrate these capabilities into our distribution platform, not only here in the US but in Europe and Canada as well. But I think that it's -- we are at obviously very early stages in terms of the size of that business, although I think from the standpoint of accretion and dilution and the impact it is having on our bottom line, it is about going according to plan.

Mike Vinciquerra - *BMO Capital Markets - Analyst*

I can't recall the number from the first quarter. Do you guys actually make money in Q1 in that business?

Howard Naphtali - *Investment Technology Group, Inc. - CFO*

No the losses were relatively consistent. They were $100,000 for this quarter.

Mike Vinciquerra - *BMO Capital Markets - Analyst*

Is there kind of a break-even commission level you are looking at, Howard?

Howard Naphtali - *Investment Technology Group, Inc. - CFO*

It is obviously higher than we are at right now, but there are some levels of investment also. We are clearly not going to get into that but the numbers overall are clearly not material from bottom line perspective at this juncture.

Mike Vinciquerra - *BMO Capital Markets - Analyst*

Okay, one question, Bob, on the European market. Have you guys been using Chi-X up to this point. What has your experience been? And has the Fortis clearing solution proved effective and a cost saver for you guys?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

We are quite pleased with Chi-X's performance. I think Turquoise from what I understand will be live August 15. That was the date that I got from my meetings in Dublin last week. It will be -- I think it was kind of one of these kind of rolling gradual build-ups in terms of liquidity and participation in Turquoise that folks are looking for through the first week in September. Turquoise also is adopting the DTCC clearing alternative Euro CCP. But it looks to us right now that between Turquoise and Chi-X, you are talking about significant savings, I am talking about factors and factors of savings over the traditional primary exchanges from an execution perspective.

The clearing model is becoming a little bit -- I think more convoluted in the near term in that you have got all the clearing facilities that are emerging as a result of these new MTFs going into production. I am sure that BATS will add some complexity to that as will others that enter the space, NASDAQ OMX, etc.. But we are confident that the competition itself is a very good thing. And so we expect good clearing improvements over time.

Mike Vinciquerra - *BMO Capital Markets - Analyst*

Okay. Thank you very much.

Operator

Your next question comes from the line of Rich Repetto of Sandler O'Neill. Please proceed, sir.

Richard Repetto - *Sandler O'Neill - Analyst*

Yes, good morning, guys.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Good morning, Rich.

Richard Repetto - *Sandler O'Neill - Analyst*

I guess I am looking at July and looking at first, volumes being up materially in Tape A, over 20%, blended Tape A and C up 16%. So I guess and volatility was up. How -- could you give us a clue about your market share of volume in July?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

No. That is the short answer, Rich. We're going to stick to our plan to disclose our numbers next Friday.

Richard Repetto - *Sandler O'Neill - Analyst*

Okay. The reason I ask is now we are going to make adjustments after that quarter -- right after this, and given what we think could be high potential margins and then we're going to make another adjustment a week after.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

I certainly am empathetic with that, but I think in the past what we found was that when we did put out a positive number, it was somehow lost in the mix of the call. We feel as I said earlier that we need to stick to our guns in terms of anything that we would consider to be negatively interpreted. We'll certainly disclose as soon as we have the numbers in hand, but I think that we are going to stick with our original plan to stay on our normal cycle -- monthly cycle.

Richard Repetto - *Sandler O'Neill - Analyst*

Okay. I guess we beat around talked, discussed this BLOCKalert, and I guess the question, is by bringing it in, is it accretive or dilutive? Maybe I missed that.

Howard Naphtali - *Investment Technology Group, Inc. - CFO*

Right now there is no material effect. It is all a question of what level of growth we can get going forward. But the current financial profile as I indicated will not have any significant effect on the bottom line.

Richard Repetto - *Sandler O'Neill - Analyst*

Okay. Then I guess we are seeing changes in volatility in the market, Bob. Is it still -- I guess one thing is on the rate. As the rate declines, at least we get -- we sort of get the idea that there would be more contact with POSIT, more of the routing was going to see POSIT before it got routed out. So any sort of more color on the decline on rate from quarter to quarter? It is still a good rate if you look at that time from year end to now but you had that spike in 1Q.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Yes. As I said, it has become very, very difficult to predict and I think that is why we are going to exit the game of providing guidance on the rate card going forward. I will say that we have worked hard to incorporate the smart router into more and more internalization opportunities in POSIT. April and May were weak months like our overall US volumes would suggest. But June was a relatively strong month on the POSIT suite side. But overall, I think the POSIT numbers are down sequentially on average the way our overall volume numbers were, it is within a percentage point or two of that.

Richard Repetto - *Sandler O'Neill - Analyst*

Let me take one last cut at this.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Sure.

Richard Repetto - *Sandler O'Neill - Analyst*

The volatility has been climbing, at least as measured by the VIX since May through July. Would you say -- is ITG a beneficiary or --

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Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

I would say this. Volatility as we said I think time and time again, does not have a negative adverse impact on our volumes today. It doesn't -- when we were a monoline, dark matching only business in the US, that was a tough place to be when the VIX and volatility overall spiked. We are not in that position today. We have a much more diverse business centered around algorithms and dark matching and DMA and smart routing is a big piece of all those things. So I'd say the volatility does not have the negative impact on the business as obviously it used to.

Richard Repetto - *Sandler O'Neill - Analyst*

Okay. Thank you.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Thank you.

Operator

Your next question comes from the line of Mr. Chris Allen of Banc of America Securities. Please proceed, sir.

Chris Allen - *Bank of America - Analyst*

Good morning, guys.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Good morning, Chris.

Chris Allen - *Bank of America - Analyst*

Hey, Bob, earlier in the call you mentioned that you are making a lot of progress on the Triton front. I was wondering if you could kind of give us -- help us figure out how that's going to translate into revenues. One of the things I am looking at is obviously your market share has been declining the last five quarters and obviously that is somewhat environmentally driven in the US. So if you could just give us some color and how you might think about the revenue opportunity moving forward?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Yes, we are talking more and more about the market share number in the US and I communicated that in broad forms before. We don't think it is a very -- going forward a very material metric to use when assessing the health of our US business, and I think that what you are going to see from us in the coming months is more and more communication on our US institutional share and what we believe are some of the things that folks might use to assess that. The -- so the Triton -- the correlation between Triton and gross market share of the US markets, NASDAQ and New York, is not very useful in my mind. The one interesting thing -- the one interesting metric we did throw out there today which we believe is probably one of its kind out there is this whole metric of LSE agency share, which is something that the LSE does provide, which is a pure -- business that you have executed purely as agent on behalf of a customer. That is unique to the LSE and does not exist here in the US. We wish it did exist here in the US, but we are going to find some other alternatives to hopefully validate what we believe to be a growing US institutional presence.

Chris Allen - *Bank of America - Analyst*

Okay. And then just on the European business, which obviously -- you guys reported a pre-tax profit in that business, and it seemed like the investment in Israel is really kind of taking down the pre-tax income from that area just on the non-Canadian International front. Any guidance in terms of -- any thoughts in terms of when that business might turn profitable or break even on the Israeli front?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Israel is purely a cost center for us today in terms of primarily development that is associated with the international business. But to be frank, there are elements of the Israeli workforce that do perform global efforts on the firm's behalf. So, it becomes all about allocation at that point in time. But the Israeli business -- the Israeli effort is purely a cost center.

Chris Allen - *Bank of America - Analyst*

Good. Thanks a lot, guys.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

You got it.

Operator

Your next question comes from the line of Mr. Daniel Harris of Goldman Sachs. Please proceed.

Daniel Harris - *Goldman Sachs - Analyst*

Good morning, guys. Thanks for taking my question.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Good morning, Dan.

Daniel Harris - *Goldman Sachs - Analyst*

Can you help me think through the compensation line a little bit, Howard? How much of that is fixed salaries versus variable compensation? And that variable compensation, is that tied strictly to sort of a metric you guys use internally whether it's earnings or cash flow?

Howard Naphtali - *Investment Technology Group, Inc. - CFO*

The variable compensation, as we talked about in prior years, is a factor of looking at certain growth hurdles that we are expecting during the budget cycle largely on pre-tax income and to a lesser extent on revenues, and the growth in that as a function of hitting or exceeding those hurdles. Obviously in the first quarter, we hit a home run with our highest volumes, earnings and the whole bit. So consequently, there was a significant amount of incentive compensation, accruals and profit share and the numbers pulled back in the second quarter, and consequently you saw the lower compensation expense. It's merely a mathematical function of that.

Daniel Harris - *Goldman Sachs - Analyst*

Okay, but do you -- is there a salary run rate you guys have in terms of year-over-year what the salary number has been versus bonuses?

Howard Naphtali - *Investment Technology Group, Inc. - CFO*

Again that's a level of disclosure we are not going to get into. We have given you guidance as to where the compensation rate will be overall and we've been well within this guidance for a long time.

Daniel Harris - *Goldman Sachs - Analyst*

Okay. And Bob, this one is for you. Another quarter into what has been an extremely volatile year almost. How would you characterize how your clients are using your systems today versus what you would have thought they would have used or the way they used them a year ago?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

I would say that the EMS has really grown up from the perspective of more and more functionality that folks are looking to us to provide, whether or not it is routing to other third parties, which has grown significantly or it's more and more OMS-like functionality. And it really brought us a year and a half ago to that stage of the game or actually -- yes, about a year and a half ago to that stage of the game where we felt it was incumbent upon us to think of the next generation desktop which is really we talked about time and time against Triton X and the assimilation of EMS and OMS functionality into one, but the trend of our EMS clients wanting more and more functionality delivered through the EMS desktop is something that I think continues to positively surprise us both here domestically, in Canada and abroad.

Daniel Harris - *Goldman Sachs - Analyst*

So that's like the EMS-OMS combo or it that just more specific EMS?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

No the existing customer base today.

Daniel Harris - *Goldman Sachs - Analyst*

Okay. Just lastly, and you guys have obviously picked up a number of acquisitions over the years, but as you think about the current landscape with the amount of dark liquidity pools out there, one of the things we haven't seen is any major combinations of liquidity pools on the dark side. Do you think that is even something that comes down the pike, or do you just think that winners will emerge down the road with more liquidity and others may just go away?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

It is hard to predict. I think there are a number of dark pools that have been in existence for probably quite some time at this point and the question is whether or not they can continue to support critical mass and whether or not their economic models, their business models, support long-term viability. And whether or not that forces their hand into a combination or just -- or they fade into the background is I think the question up for debate at this point. I think the market in the US right now has been fairly optimal for us from the perspective of, yes, it is a competitive environment, but we've also manage to leverage that on the cost side very effectively.

So dark fragmentation, competition amongst liquidity pools, all the things that have existed in the US that we are hoping for in Europe, I think will have a continued benefit for us. But in terms of the overall competitive landscape, it is very difficult to predict right now. I think in terms of whether or not their will be some consolidation or just some firms will disappear into the woodwork. I don't think - some of the consortium-led stuff - it is hard for me to envision a scenario if a firm is struggling that consortium partners are going to re-ante to stay in the game.

Daniel Harris - *Goldman Sachs - Analyst*

Right. And then just lastly do you think your buy side clients get confused at all with all the options out there or do you think they are comfortable with you guys acting as a smart order router and helping get to the liquidity?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

I think sometimes it requires a significant amount of education on our part and that has historically led to strong adoption of ITG's products, but my -- I think our view of the future is that we will continue to not only differentiate POSIT from the rest, but we will also -- and we are going to come out with more and more data with more and more research, and I think we will effectively communicate that, but I think that it is. It is a crowded space. It is a complex space, but that's what we do. We demystify electronic trading and the challenges that evolutions in market structure present to our clients.

Daniel Harris - *Goldman Sachs - Analyst*

Thanks very much for taking my questions.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Thank you.

Operator

Your next question comes from the line of Mr. Rob Rutschow of Deutsche Bank. Please proceed.

Rob Rutschow - *Deutsche Bank - Analyst*

Hi, good morning.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Good morning, Rob.

Rob Rutschow - *Deutsche Bank - Analyst*

I guess my question is around Europe. It sounds like you need some structural help from changes in market structure to get the clearing and execution costs down over there. So I am wondering if you can kind of segment how the transaction expenses break down between clearing and execution in Europe and what gives you more confidence that you will see lower expenses going forward?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

We have chosen not to do that, not to segment those subsets of transaction processing costs. But I will tell you that going forward, that if we do have -- and as I said in my prepared remarks, I was in Dublin last week. Sat down with the European management team, and feel good about our plan for addressing that component piece of our cost structure going forward, and I am optimistic given the time table for future releases of MTFs going into production that a lot of the goals that we've set for ourselves internally will come to fruition.

The one other piece that we haven't spoken about is certainly market data is a challenge. I briefly alluded to that in my prepared remarks. We are in some ways tactical, but the numbers add up. We are getting more and more experience in terms of our employment market data globally with our desktop. So in the old days, a client will take Triton down and ask for everything, and then would episodically trade, so we have become a lot smarter about how we deploy the market data and ultimately what we are forced to eat, and we think there is quite a bit of, as I said, tactical pruning to be done there, but it adds up into real numbers.

Rob Rutschow - *Deutsche Bank - Analyst*

But is there any level of activity on the MTFs that we should look for as sort of a turning point for you in terms of the ability to cut costs?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

I don't really have any market share numbers in mind, but I will tell you that these guys I'm sure will be very vocal very quickly about their market share numbers and what they are taking away from the primary exchanges. And I got to tell you I think every major broker in the market has got their guns pointed at these things and is ready to go. So I am sure there will be quite a bit of information out there in the first few weeks of September that will give folks some ability to discern exactly what kind of progress they are making.

Rob Rutschow - *Deutsche Bank - Analyst*

Okay. And last question on expenses. Did you guys have any bonus reversals this quarter?

Howard Naphtali - *Investment Technology Group, Inc. - CFO*

Again as I said the incentive compensation is a function of whether we hit the hurdles established during the budget process and you have to adjust each quarter based upon the actual results you've had. So we had a huge growth rate in the first quarter and obviously our six-month growth rate, excuse me, is lower than the first quarter?

Rob Rutschow - *Deutsche Bank - Analyst*

Okay. Thank you very much.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Thanks, Rob.

Operator

Your next question comes from the line of Mr. Josh Elving of Piper Jaffray. Please proceed, sir.

Josh Elving - *Piper Jaffray - Analyst*

Hi, good morning.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Good morning, Josh.

Josh Elving - *Piper Jaffray - Analyst*

Question on -- just another additional question on Europe. I guess I am trying to get a little bit of a better sense for if you have any kind of targets for profitability or timing, I guess, looking out over the next year or two. I know that there's a lot of higher costs that you need to get down, and I guess I am just trying to get a sense for what you think on timing and what is the margin that you could potentially generate in Europe?

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

Timing, Josh, has become nearly impossible for us to predict, I think at this moment in time. It is clearly the conditions in Europe are abysmal in terms of institutional trading, but I think we have managed to more than hold our own which we are obviously pleased with. We continue to take share institutionally, and that is our belief there. But it forces us to think a little bit -- and as

I said earlier, a little bit more conservatively about not only our variable but our fixed expenses there, and you can rest assured that we are monitoring the situation closely and we'll make the adjustments as necessary.

In a normal European business environment where institutional turnover was where it was for years like '06 and '07, I think our view has been that we would have been clearly within reach of our stated goals which was to be -- to make progress through the high teens and into the low 20%s in Europe in terms of our pre-tax operating profit. We are confident that when we get to a critical mass, we will be able to do the same things that we've done with Canada where we are now in excess of 30% of the US margin goals. It's unfortunate from a timing perspective, but as I said as well in my prepared remarks, we don't believe it is the time to retrench or pull back, and our market share numbers give us the confidence that it really behooves us to continue on.

Josh Elving - *Piper Jaffray - Analyst*

Okay. That's helpful. I guess just most of my questions have been answered. A couple of numbers questions. Did you have depreciation amortization or CapEx numbers handy?

Howard Naphtali - *Investment Technology Group, Inc. - CFO*

They will be in the 10Q that will be out next week.

Josh Elving - *Piper Jaffray - Analyst*

Okay. I guess, one more question on international. The tax rate -- if I can kind of back into a tax rate for the international piece. It seems like it is kind of high running maybe 50%, 60% in the last two quarters. What is driving that? It seems that international tax rates are traditionally a little lower than the US.

Howard Naphtali - *Investment Technology Group, Inc. - CFO*

Right, when you are earning money that's true and it depends on how conservative you are from an accounting standpoint. As we said numerous times over the past few years, we are not doing what a lot of companies do. You can book a deferred tax benefit on the hope that you will have future profits. We have never earned a profit in Japan, so consequently we have fully reserved all potential tax benefits over the years. When we make a profit, it would be a huge reversal in there. Similarly as Bob alluded to our development center in Israel is a cost center and that has some negative arbitrage from a tax rate perspective. The flipside of that equation is when you have subsequent earnings you are correct in low tax jurisdictions with the European broker dealer business being in Dublin with 12.5% tax rate, the Asian headquarters in Hong Kong, which has a 16.5% tax rate and even Australia's at 30%. So it is all a function of being in the black to get the positive leverage.

Josh Elving - *Piper Jaffray - Analyst*

Thank you very much.

Howard Naphtali - *Investment Technology Group, Inc. - CFO*

Thank you, Josh.

Operator

At this time, there are no further questions in the queue, and I would like to turn the call back over to Mr. Bob Gasser. Please proceed, sir.

Bob Gasser - *Investment Technology Group, Inc. - CEO, President*

We thank you for joining us today and we look forward to sitting down with you in November.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Good day.
