



November 25, 2005

VIA EMAIL (RULE-COMMENTS@SEC.GOV)

Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Comment on Proposed Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934 (File No. S7-09-05)

Dear Mr. Katz:

ITG Inc. (“ITG”) is pleased to offer its comments with respect to the above-referenced release (the “Proposing Release”), pursuant to which the U.S. Securities and Exchange Commission proposes to provide interpretive guidance with respect to client commission practices under Section 28(e) (“Section 28(e)”) of the Securities Exchange Act of 1934 (the “Exchange Act”).

ITG lauds the Commission’s efforts to provide guidance to the financial services industry concerning the scope and interpretation of Section 28(e). In the Proposing Release, the Commission describes and proposes to revise its interpretation with respect to several aspects of Section 28(e), and also proposes to describe its views with respect to several other matters, such as the scope of the term “brokerage,” as used in Section 28(e).

Summary

A. Brokerage

(i) The “temporal” concept should be eliminated from the proposed definition of “brokerage”, or, at a minimum, modified, as it does not appropriately capture the scope of brokerage services provided by brokers to their clients and is not supported by the legislative history relating to Section 28(e).

(ii) The Commission’s blanket rejection of order management systems (“OMSs”) should be modified to take into account that many aspects of OMSs are clearly “brokerage” and OMSs can also provide “research” functionality.

B. Research

For the most part, we have no comments on the Commission’s proposed treatment of “research” in the Proposing Release. However, we do believe that it would be helpful to the financial services industry if the Commission could provide more clarification as to the status as “research” of analytical products and services (such as pre-trade and post trade analytical tools). The Proposing Release has raised some questions in this regard.

C. Phase In

We suggest a brief, six-month, phase in period following release of final Commission rules, to provide money managers and brokers a time period in which to adjust their uses of commission dollars.

Discussion

(1) The Temporal Concept of “Brokerage”

We believe that the Commission’s revised framework for interpreting what constitutes “brokerage” does not appropriately capture the scope of services provided by brokers (both historically and currently¹) in their capacity as “brokers”. In that regard, we focus primarily on the Commission’s proposal to include a temporal element in the definitional framework. Specifically, the Commission proposed that, for a product or service to constitute “brokerage,” it would need to fall within a time frame that begins when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are delivered or credited to the advised account or the account holder’s agent.²

Section 28(e) says that a person provides “brokerage services” if they effect securities transactions and perform functions incidental thereto (such as clearance, settlement, and custody).³ The Commission states that, in recognition of the “technological explosion” in the money management industry, a “temporal” standard is needed to guide the industry as to the distinctions between brokerage and overhead.⁴

The Commission also suggests that the inclusion of a temporal standard is justified because of its concern that products and services proposed to be stripped out of the “research” designation under the Commission’s proposed revised interpretation of the term “research” will inappropriately be redesignated by industry participants as “brokerage”.⁵

-- Historical and Current Industry Perspective

The Commission says that the framework for determining what constitutes “brokerage” should reflect “historical and current” industry practices. We suggest that the imposition of a temporal concept is not supported by an examination of either historical or current industry practices.

In the past (*i.e.*, prior to the current state of affairs where technology is often involved in each facet of portfolio management and trading processes), as well as today, brokers fulfill the role of advising their money manager clients as to the best strategies to employ to make their trades the most efficient and profitable. In the “old days”, this would have most often been accomplished during a telephone conversation between the broker and the money manager perhaps inquiring as to the depth of the market in a stock or the difficulty of trading a basket of stocks. Today, often,

it is accomplished by means of sophisticated trading and analytical technologies either employed directly by the broker in effecting trades or provided by the broker to the money manager (often residing on-site with the money manager). Both historically, as well as currently, this type of information and advice, which is certainly integral to the trade execution process, would have been communicated to the money manager prior to the money manager's direction to a broker to execute a trade, or sometimes, in the case of a larger worked order, in the midst of a multi-faceted trade. While we agree that brokerage is a process, we do not agree that it is capable of being defined by a bright line test which begins upon the electronic transmission (or verbal communication) of an order for execution. Rather, we believe the services provided to money managers by brokers that provide assistance or advice to the money manager in determining an execution strategy prior to execution of a trade should continue to be defined within "brokerage". Moreover, we suggest that these services fit squarely within the "lawful and appropriate assistance" standard, which the Proposing Release helpfully clarifies applies to the provision of "brokerage".⁶

-- Determination Should Be Based on the Nature of the Services Provided, Not Based on When They Are Provided

In addition to the various information related tools that brokers supply to their money manager clients, many brokers (including ITG) provide such clients with on-site execution and analytical tools. A significant (and growing) portion of trades are executed directly by buy side trading desks of money managers to trading floors and other execution venues via broker connections.⁷ In this regard, we believe that the characterization of a product under Section 28(e) should be based not on when it is employed, but rather, it should be based on its function. As the Commission noted on page 34 of the Proposing Release, "trading software operated by a broker-dealer to route orders to market centers and algorithmic trading software is 'brokerage'". We do not believe that this characterization should change if the execution or analytical tools provided by a broker are operated by a money manager prior to communication of an order. The Commission's proposed temporal definition of brokerage produces an incongruous result -- if execution and analytical technologies are employed by brokers to determine how to best handle a previously communicated order, they constitute "brokerage" services provided by the broker. If, however, these same tools are provided to money managers by brokers for use by money managers (often in conjunction with assistance and advice from their broker regarding implementation) they would not constitute the provision of brokerage services.

-- Legislative History

We found no support in the legislative history to Section 28(e) for the inclusion of a temporal standard in the definitional analysis for determining whether a product or service constitutes "brokerage". In fact, our review of the legislative history indicates that the terms "brokerage" (as well "research") were meant to be interpreted very broadly. On one hand, the Commission says that "brokerage and research services" must be interpreted ... "in light of Congress's

intention to provide a limited safe harbor for conduct that otherwise may be a breach of fiduciary duty.”⁸ ... [and that] ... “since Section 28(e) involves a statutory exemption for conduct which might otherwise constitute a breach of fiduciary duty owed by a money manager to his client, the Commission believes that the section should be construed in light of its limited purposes.”⁹

On the other hand, the Commission acknowledges Congressional legislative history which said that: “[t]he definition of brokerage and research services is intended to comprehend the subject matter in the broadest terms, subject always to the good faith standard in Subsection (e)(1).”¹⁰

It is important, we believe, to note that the support for the Commission’s assertion that Section 28(e) should be interpreted narrowly was derived from an SEC administrative proceeding, the subject matter of which did not involve the determination of whether particular products or services constituted research or brokerage.¹¹ As noted above, there is a Congressional directive “on point” to interpret brokerage and research in their “broadest terms”. Therefore, it is not clear to us that the legislative history underlying Section 28(e) supports an argument for a narrowing by the Commission of the scope of what constitutes brokerage (or research).

-- Conclusion

If the Commission determines, notwithstanding the foregoing, to maintain a temporal standard, then, at the very least, we believe that the point for the start of the brokerage temporal period should be modified. Indeed, if the beginning and the end of the brokerage period is meant to reflect current and historical industry practices, then the period should begin once a decision to trade is made (e.g., when a buy-side portfolio manager makes an investment decision) and should include the period of time during which services are provided by brokers in assisting money managers to determine execution strategies to achieve their investment objectives. This standard would be consistent with the clear trend in the market for buy-side trading desks to execute orders directly (by means of tools and with advice supplied by brokers). Moreover, we believe it more accurately reflects the scope of “brokerage” services historically and currently provided by brokers to their clients. To do otherwise would, in our view, create an artificial and inappropriate divide between the concepts of brokerage and research.

(2) Comments on the Definition of Brokerage and its Application to OMSs

We are concerned with the statement in the Proposing Release that order management systems do not qualify as brokerage. The Commission says that ... “order management systems (“OMS”) used by money managers to manage their orders (including OMS developed in-house at the manager and those obtained from third party vendors)”... are not eligible for the safe harbor brokerage because they are not sufficiently related to order execution and fall outside the temporal standard for brokerage under the safe harbor.¹²

While we would agree that there are aspects to OMSs that may not necessarily constitute brokerage under the Commission's proposed definition, there are indeed many aspects that would qualify as brokerage. An important component of the modern OMS offering is the network of connectivity (and the functionality to exploit such network) the OMS provides among brokers and execution venues. Many OMSs provide money managers the ability to trade from the OMS, including electronic connectivity to brokers, broker provided algorithmic trading systems, markets and other execution functionality. Indeed, there has been a transformation in the OMS market (which is expected to continue) where OMSs include many of the types of items that the Commission specifically refers to as constituting brokerage, as well as the addition of quantitative "research" functionality to OMSs. The implication of the Commission's statement, however, is that under the proposed interpretation OMSs will not fit within the meaning of brokerage. We believe that, because of the multi-functionality of OMSs, they should be treated similarly to any other type of multi-use product or service – that is, the money manager should be required to perform a mixed-use analysis on the product or service; and may only "soft dollar" those uses which constitute brokerage or research. A flat statement that OMSs do not qualify as "brokerage" however, as was done by the Commission in the Proposing Release, appears to us to be unwarranted given the many "brokerage" (and in some cases, "research") applications of OMSs.

(3) The Scope of "Research"

For the most part, we have no comment on the analytical framework set out in the Proposing Release for determining whether a product or service constitutes "research". We believe that the Proposing Release provides appropriate refinement to the framework set out in prior Commission precedent over the last 20 years.

Instead, our comments with respect to "research" relate to the delineation of research products and services in Section III.C. of the Proposing Release. There, the Commission identifies very generally a variety of types of products or services that may or may not constitute research¹³. While we understand that the Commission was not attempting in the Proposing Release to list every category of product and services that may or may not constitute "research", we found it notable that a large and varied class of products and services that constitute "research" are conceptually subsumed (without specific description) under a single reference to certain "analytical software" in the Proposing Release.¹⁴

We believe that it would be helpful to the industry if the Commission could provide more clarification as to the status of the significant universe of sophisticated analytical software products and services made available to the financial services industry by various brokers and vendors (including ITG). We suggest this, in part, as a result of the many queries we have received from our money manager customers seeking to understand the status of trade analytics, including pre-trade and post-trade tools, under the Proposing Release.

Analytical tools address a critical need for money managers at each level of the investment process. At ITG, we stress that the performance of an investment reflects both a portfolio manager's investment strategy and the execution costs incurred in realizing those objectives. Those execution costs can be significant, especially when compared with gross returns. Studies show¹⁵ that implicit costs, most importantly the price impact of a trade, account for 75-90% of total execution costs. As structural and regulatory changes have brought increasingly fragmented liquidity to today's equity markets, the importance of accurately measuring such costs increases.

Money managers often seek to ensure that cost analysis and "cost awareness" exist at every step of the investment cycle, from portfolio construction¹⁶ to pre-trade strategy planning¹⁷, from execution to post-trade analysis. Such analyses provide a feedback loop that can be used to inform decisions at every step in the investment decision making process.

ITG, along with other brokers in the financial services industry, provides money managers with a variety of portfolio construction, analysis and trading tools that allow a money manager to control cost and risk based on insights from each phase of the investment process. These tools contribute significantly to a money manager's ability to satisfy its best execution obligations.¹⁸ Many in the industry tend to analyze money managers' best execution obligation in terms of commission costs. However, it is clear from Commission pronouncements on the topic that commissions are but one relevant component of the best execution analysis. In fact, best execution has historically been viewed by the Commission as an obligation on the part of the money manager to see to it that securities transactions are executed "... in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances."¹⁹

One of the better examples of the potential positive impact of analytical tools upon the satisfaction of the best execution obligations of money managers is in the context of post-trade analysis. Post-trade analytical tools ("Post-Trade Tools")²⁰ can assist in determining the optimal way to trade securities in accordance with a money manager's objectives. They help money managers lower transaction costs, manage risk, access liquidity and optimize portfolio decisions, thereby assisting money managers in the satisfaction of their duty to clients to seek best execution.²¹ Such Post-Trade Tools are designed to provide money managers with tactical and strategic measures of trading cost measurement, permitting the development and monitoring of suitable trading cost benchmarks and allowing institutions to adjust their trading strategies to optimize trade execution and overall performance.

Another aspect of a Post-Trade Tool is to assist in determining proper portfolio construction, *i.e.*, the Post-Trade Tool can be used in conjunction with pre-trade analytical tools to assist in assessing the likelihood of realizing "net alpha," which in this case is alpha after deducting the cost of trading²². As an example, a money manager may input data from a large trade of a small-cap stock which took several days to complete. The money manager would use the Post-Trade Tool to assist in determining the days and times of the day in which the trades were executed

most efficiently. It would also assist the money manager in spotlighting risk, the impact of price and the volatility associated with the trading.

Using a Post-Trade Tool to assist the money manager in capturing net alpha, and improving investment performance by reducing costs, is directly related to the duties of the money manager to purchase and sell portfolio securities and select brokers and negotiate prices for the benefit of its clients and to its responsibilities regarding investment decisions. Clearly, in our view, many of the uses of the Post-Trade Tool constitute “research”.

There are, of course, certain potential uses of a Post-Trade Tool that would not constitute “research”. For example, while a Post-Trade Tool does not determine the compensation or other benefits to be paid to employees of the money manager, by assisting in determining the effectiveness of portfolio managers and research staff, the money manager could potentially use the Post-Trade Tool as a factor for determining salaries, bonuses, and whether or not an employee should be retained. Such a use would not constitute research. Similarly, the use of Post-Trade analysis for marketing purposes would be a general overhead function of the money manager, and not related to its investment-making decisions. A money manager would need to “mix-use” such non-research uses.

We believe that because of the significant role played by analytical tools in the research function of most money managers and the many queries we have received in this area from our clients, it would be very helpful to the industry for the Commission to delineate some additional functionality of analytical software (both pre-trade and Post Trade analytics) that continue to constitute “research” under the Commission’s proposed interpretation.

(4) Phase In Period (Response to Commission Question 10)

In satisfying the “provided by” requirements of Section 28(e), many brokers have obligated themselves to pay for products and services under long term contracts with third parties which in some cases are not immediately cancelable by the broker. To the extent that a broker is providing services which fall outside of the definition of “research” or “brokerage” under the final Commission rules, we believe brokers should be provided a window of time to “phase out” such arrangements. In this way, brokers who have been complying with the parameters of Section 28(e) on behalf of their clients are not unfairly economically disadvantaged by the immediate effectiveness of the Commission’s rules in this area. Similarly, we believe it would be appropriate to provide an implementation window for money managers to adjust their use of commission dollars as needed to comply with the final rules. Accordingly, we would suggest a six-month period between the release of the Commission’s final interpretation and the date of its effectiveness.

* * *

We would be pleased to discuss our views on this issue with the Commission or its staff. Please contact the undersigned at (212) 444-6162, if you have any questions.

Very truly yours,



Saul P. Sarrett
Director
Deputy General Counsel

cc: P. Mats Goebels, Esq.
Ian Domowitz
ITG Inc.

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¹ The Commission said that: brokerage under Section 28(e) should reflect historical and current industry practices that execution of transactions is a process...and...that this temporal standard is an appropriate way to distinguish between “brokerage services” that are eligible under Section 28(e) and those products and services, such as overhead, that are not eligible. Proposing Release, at 33.

² Proposing Release, at 34.

³ 15 U.S.C. 78bb(e)(3)(C). Section 28(e)(3)(C) of the Exchange Act, says that a person provides “brokerage . . . services” insofar as he or she:effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith by rules of the Commission or a self-regulatory organization of which such person is a member or in which such person is a participant.

⁴ The Commission refers to a 1998 report of its examination staff which said that: [t]he technological explosion in the money management industry has been met with an increasing use of soft dollars to purchase state-of-the-art computer and communications systems that may facilitate trade execution. . . . The use of soft dollars to purchase these products may present advisers with questions similar to those surrounding computers purchased for research and analysis, *i.e.*, how should an adviser distinguish between ‘brokerage’ services and ‘overhead’ expenses. 1998 OCIE Report, at 35-36, 50.

⁵ Proposing Release, at 34.

⁶ Proposing Release at 36.

⁷ Institutional Equity Trading in America 2005: A Buy-Side Perspective, TABB Group, June 2005, at 12.

⁸ Proposing Release, at 25.

9 Id.

10 Proposing Release, at 25, citing, Senate Comm. on Banking, Housing and Urban Affairs, Securities Acts
Amendments of 1975, S. Rep. no. 94-75, at 71 (1975), reprinted in 1975 U.S.C.C.A.N. 179, (the “Senate
Report”), at 249. Bear in mind, that the “good faith standard” referred to in the quoted language refers to
the fact that the Section 28(e) safe-harbor is only available if the money manager determines in “good
faith,” that the amount of commissions paid is reasonable in relation to the value of the brokerage and
research services provided. The “good faith standard” is not related to the framework for analyzing
whether a product or service constitutes “research” or “brokerage”.

11 Report of Investigation in the Matter of Investment Information, Inc. Relating to the Activities of Certain
Investment Advisers, Banks, and Broker-Dealers, Exchange Act Rel. No. 16679 (3/19/80) (the “III
Report”). In fact, the Commission went so far as to indicate in the III Report (which involved an
interpretation of the “provided by” requirement of Section 28(e)), that the result in that proceeding would
have been the same whether or not the products or services had qualified as “brokerage” or “research.”

12 Proposing Release at 35

13 For example, the Proposing Release characterizes as eligible under Section 28(e) “traditional research
reports analyzing the performance of a particular company or stock”, “certain financial newsletters” and
certain “seminars or conferences”.

14 The Proposing Release says that quantitative analytical software and software that provides analyses of
securities portfolios would be eligible under the safe harbor if they reflect the expression of reasoning or
knowledge relating to subject matter that is included in Section 28(e)(3)(A) and (B). For this proposition,
the Proposing Release cites Senate Comm. on Banking, Housing an Urban Affairs, Securities Acts
Amendments of 1975, S. Rep. No. 94-75, at 71 (1975), reprinted in 1975 U.S.C.C.A.N. 179, 249 (computer
analysis of securities portfolios would be covered”).

15 I Domowitz, I., Glen, J. and Madhavan, A., Global Equity Trading Cost (2001),
<<http://www.itginc.com/research/whitepapers/domowitz/globalexcost.pdf>>

16 Transaction costs should be taken into account in the portfolio construction phase since such costs can have
a significant impact on asset allocation and returns (*e.g.*, while one security may appear more attractive
than another, it may be more advisable to acquire the less attractive security where the security with better
prospects is traded in a higher cost market). Id.

17 Once a portfolio manager has made the assumptions and analysis necessary to determine asset allocations
and create a portfolio of securities, it is essential that he or she convey those underlying assumptions to the
trading desk or the trader who is about to execute the orders. Making clear the time frame in which the
portfolio manager expects to accomplish the program and the cost estimates the manager expects can save
all parties significant expense. When planning an execution strategy, we believe that traders should be
aware of the relationship between price impact and opportunity cost (*i.e.*, the risk that an advantageous
opportunity will be lost by delaying a trade). An aggressive strategy will increase price impact and lower
opportunity cost. A passive strategy, by contrast, will reduce price impact but increase opportunity cost. A
good execution strategy will always take into account both the estimated costs of a portfolio manager’s
investment strategy and the price impact and opportunity costs of executing that strategy.

18 1986 Release, *supra* note 1.

19 1986 Release, at part V.

20 This description of a Post-Trade Tool is closely based upon products and services made available by
companies such as ITG, Plexus Group and other brokers and providers.

21 It is important to bear in mind that many of these Post-Trade Tools aid the money manager in obtaining
best execution on a forward looking basis, as opposed to, or in addition to, measuring whether best

execution was obtained. We emphasize this point in contrast to the statement of the Commission in the Proposing Release (at footnote 98) to the effect that trade analytics used by a money manager to assess whether it has complied with its duty to obtain best execution would not constitute research.

22

In the investment management industry, “alpha” is generally defined to mean the portion of an investment’s return arising from specific (non-market) risk. It measures the difference between actual returns and expected performance resulting from exposure to specific risk factors. It is often referred to as an investment manager’s “value added” (or “value subtracted,” as the case may be). “Net alpha,” assists in determining the true investment performance of an investment manager’s strategy after subtracting the cost of trading (both efficient and inefficient trading). *See* [surreycc.com](http://www.surreycc.com) (3/30/04), <[http://www.surreycc.gov.uk/legcom/CouncilP.nsf/0/0fb36222a813e75480256d6d004ba992/\\$FILE/Item%2010%20Annexe%203.pdf](http://www.surreycc.gov.uk/legcom/CouncilP.nsf/0/0fb36222a813e75480256d6d004ba992/$FILE/Item%2010%20Annexe%203.pdf)>