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ITG - Q2 2011 Investment Technology Group Inc Earnings Conference Call

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PRESENTATION

Operator

Good morning and thank you for joining us to discuss the Investment Technology Group's second quarter results for 2011. My name is Marisa and I will facilitate the call today.

After the speaker's remarks, there will be a question-and-answer period. (Operator Instructions). As a reminder, this session is being recorded.

I would now like to turn the call over to J.T. Farley of ITG. Please proceed.

J.T. Farley - *Investment Technology Group Inc - Director, IR and Corporate Communications*

Thank you, Marisa, and good morning. In accordance with the Safe Harbor regulations I would like to advise you that any forward-looking statements we will be making this morning are subject to a series of risks and uncertainties that may cause actual results to differ materially from those statements. These forward-looking statements speak as of today, and you should not rely upon them as representing our views in the future. While we may elect to update these forward-looking statements in the future, we undertake no obligation to do so. I advise you to read about the risk factors that may affect forward-looking statements in this morning's press release as well as in our SEC filings.

I would also like to point out that we will be referring to non-GAAP financial measures in today's presentation. Reconciliation of these non-GAAP measures to the comparable GAAP measures can be found in this morning's press release. The press release and the Power Point slides which accompany this presentation are available for download at the Investor Relations section of ITG.com.

We have with us this morning our CEO, Bob Gasser; and our CFO, Steve Vigliotti. To begin, we will turn it over to Bob.

Bob Gasser - *Investment Technology Group Inc - CEO*

Thanks, J.T. And thank you for joining us to discuss ITG's second quarter. This morning I will cover three areas. First, I will provide a financial and industry overview, including recent developments. Then offer an update on our competitive strategy. And lastly, I will discuss our capital allocation strategy.

ITG's efforts will continue focus around our core mission statement; to be the most valued partner in execution and research to the asset manager clients on a global basis. We continue to believe that our strategic direction is a sound one, built around a long term plan to capture additional commission dollars, but importantly, complemented by a disciplined approach to controlling expenses.

To work towards this goal, we acquired Ross Smith Energy Group in June, expanding our data-driven research portfolio, from both a sector and a geographic standpoint. It is still early in the integration, but so far, the client feedback has been impressive. And we expect the energy research to help us gain further traction with clients across North America, as well as in Europe. Having participated in a number of one-on-one client meetings, I can tell you, this property is truly unique and plays right to the heart of the one of the most profound secular issues of our time - reducing our dependence on foreign sources of energy.

On the expense side, a few weeks ago we made the difficult decision to initiate further cost reductions due to continued weakness in institutional equity trading volumes in the US and Europe. While Steve will cover the charges in more detail, I just wanted to summarize our plan, which is primarily focused on employment, consulting, and infrastructure costs in the US and Europe. The plan is expected to generate pre-tax cost savings in 2012 of more than $20 million or approximately $0.30 per diluted share after taxes. The cost savings will begin to take effect during the third quarter of 2011.

With this plan, we believe we will sharpen the focus of our core execution platform, improve our profitability and continue the build-out of ITG investment research, all of which are consistent with our strategic direction and critical to our long-term success. Our products and services continue to be market-leading, according to just about every third party survey. I am confident that our fantastic colleagues will help us maintain that market leadership.

As it relates to the industry, the second quarter market data underscores the rationale behind our cost reduction actions. Net outflows from domestic equity mutual funds were approximately $25 billion. These numbers demonstrate the continued negative investor sentiment towards domestic equities, particularly as volatility increased during the second quarter.

Overall, US trading activity was weak in the second quarter, with combined New York Stock Exchange and NASDAQ average daily volume down 31% year-over-year and 11%, sequentially.

In terms of our second quarter volumes, ITG continued to outperform in this tough environment, with average daily US volume in the second quarter down just 4% over the prior year period and nearly flat from Q1. POSIT average daily volume improved to 82.7 million shares, up almost 20% from last year. Average block size in POSIT Alert in Q2 was 37,000 shares. Overall revenue capture per share during the quarter declined, due in large part to continued weakness in traditional, long-only volumes. Steve will offer some more color on the various components of our mix in a few minutes.

Turning to our international operations; Asia-Pacific posted a record quarter with $10.4 million in revenue while further narrowing operating losses to $1.6 million. Dark liquidity is gaining traction across the region and we are well-situated to capitalize on this trend.

In the second quarter, Asia-Pacific volumes traded in POSIT Marketplace were nearly triple those in Q1, driven by an increase in the number of clients regularly participating. And average price improvement over the quarter was consistent, at 13 basis points across all trades. POSIT Marketplace in Asia is currently available for Hong Kong and Australia and we expect to roll it out for Japanese equities before year-end.

Canada held its own in a tougher environment with drastically weaker market volumes. We are working to gain a larger share of wallet with our Canada clients and we expect the growth of ITG Investment Research, particularly the addition of energy coverage will aid our efforts there. There are several large Canadian institutional clients that have historically been closed to us without a research offering. We believe the revenue synergies could be very attractive as we bring on clients that are new to our execution platform and also introduce the product to our existing Canada customers.

In addition, our Canadian CEO, Nick Thadaney, is also spearheading our move into the foreign exchange market, as we have identified some key opportunities which merit more exploration. We believe integrating transparent foreign exchange capabilities into our platform could yield significant client benefits and also help us increase our share of cross-border trade flows. This past week, we executed our first truly bundled international portfolio across 18 markets and 13 currencies, on behalf of a large US pension fund.

In Europe, the ongoing sovereign debt crisis has dampened sentiment, increasing risk aversion and reducing turnover levels in institutions, particularly the long only firms, which make up the bulk of our business in the region. The European management team is focused on managing costs and improving efficiencies, as well as looking for new client opportunities. While we saw revenues decline about 5% over the prior quarter, overall market value traded, as measured by BATS, dropped nearly 10%. We continue to gain share in Dark liquidity, with POSIT making up more than 6% of overall Dark trading in Europe during the quarter, up from less than 5% in the prior quarter.

Moving on to Investment Research; IR is meeting our expectations and we continue to develop it into a more material source of our overall trading revenues. We believe the combination of independent, data-driven, alpha-generating research, with best-in-class global execution capabilities provides a compelling value proposition to clients. And we remain committed to expanding the research offering over the course of 2011.

Let me touch on a few highlights. The Ross Smith acquisition introduced more than 60 new equity fund manager clients to ITG and brought our total companies under coverage to over 300 across more than 20 sectors. We hired derivative strategist, Ralph Edwards, who has hit the ground running with daily recommendations of option strategies related to the ITG IR product, as well as analysis of market volatility and technical indicators. We now have 135 accounts which are paying for research through an ITG trading relationship, including approximately 40 which were completely new relationships for ITG prior to the creation of the ITG IR platform.

During the quarter, we also launched coverage on the medical devices sector with the hiring of Dale Shivnarain, and softline retail with the hiring of Linda Tsai.

We initiated on LinkedIn. With a growing number of public companies in the social media space, our independent research represents good alpha-generating opportunities in the marketplace. We made differentiated alpha-generating research calls on names like Starbucks, Expedia, Cabot Oil and Gas and PetroHawk.

On the execution front, ITG was recognized as Best Agency Broker in a poll of Waters magazine's 10,000 readers in the industry. This result, along with top rankings earlier this year in several categories from industry groups such as Greenwich Associates and Tabb Group demonstrates the strong competitive position of our products and services. Our execution platform, coupled with the growing alpha-generation capabilities of ITG Investment Research is well-positioned to take share from more established, traditional brokerage firms and investment banks.

Moving on to our capital allocation; during the quarter, we repurchased 340,000 shares, with activity somewhat muted by our restrictions on our buybacks due to material ITG news events, namely the goodwill write-down and cost reduction measures. Going forward, we intend to pursue a balanced approach towards capital allocation; returning capital to shareholders commensurate with our level of earnings, while simultaneously investing in strategic business initiatives. We certainly view our stock as attractively valued at current levels, but we also believe it is important to deploy capital to enhance the firm's future growth prospects.

We are very pleased with the ongoing transformation of our firm as we add research content to our product mix. Majestic and Ross Smith, now ITG Investment Research, are as differentiated in their approach to alpha generation, as ITG has been to alpha preservation. As measured by the client response so far, the combination is a very powerful one.

To sum up, we are weathering these difficult operating conditions and are anything but complacent about our standing in the market. We are taking costs out of the business, selectively investing to improve our growth prospects and recasting the firm as a differentiated research broker. While we cannot predict the level of institutional trading activity in the future, I am confident that we have taken steps to gain share and to becoming an increasingly important partner to our clients across a wide range of trading and investment functions.

With that background, I would like to turn it over to our CFO, Steve Vigliotti, to take you through the key Q2 financial developments.

Steve Vigliotti - *Investment Technology Group Inc - CFO*

Thanks, Bob, and good morning, everyone. The reacceleration of flows out of domestic equity funds during the second quarter led to a further decline in institutional volumes, resulting in a business mix shift that has reduced our revenue capture rate, per share, in the US, along with our topline revenue and profitability.

On the international front, a record revenue quarter in the Asia-Pacific region helped us post improved results in our international business, despite a challenging environment in Europe.

As noted on slide six, we generated revenues of $142.6 million during the second quarter, 5% lower than the first quarter of 2011, and 8% lower than the second quarter of 2010.

On a GAAP basis, we incurred a net loss during the quarter of $4.77 per share, compared to net income of $0.23 per share in the first quarter of 2011 and net income of $0.17 per share in the second quarter of 2010.

On a consolidated basis, we generated revenues of $1.3 million from our new Energy Research operations, post the June 3rd acquisition of Ross Smith, with associated costs of $1.1 million. The $1.1 million of costs included $60,000 of intangible amortization costs and $160,000 of stock-based incentive compensation, associate with retentive awards given to the management team.

On slide seven, we have detailed the non-operating items included in our GAAP results for the second quarter of 2011 and the second quarter of 2010. There were no non-operating items in the first quarter of this year. As previously announced, in the second quarter of 2011, we wrote down a portion of the goodwill in our US reporting unit, we incurred charges associated with our cost reduction plan, focused on reducing employment, consulting and infrastructure cost in the US and Europe. And we incurred costs related to the Ross Smith acquisition, including legal and other professional fees, as well as costs for terminating a distribution agreement with a third party.

The goodwill impairment charge was driven by the continued weak environment for institutional equity trading volumes and a decline in industry market multiples. This non-cash charge had no impact on debt covenants, cash flows or normal day-to-day business operations. Later on, I will provide details on how we expect the cost reduction plan and the Ross Smith acquisition to impact future results.

In the second quarter of 2010, we recorded a non-cash goodwill impairment charge of $5.4 million to write-off the entire amount of goodwill attributable to our Australian operations. And we recorded a restructuring charge of $2.3 million primarily related to the closing of our Japanese on-shore operations.

Excluding these charges, adjusted net income for the second quarter of 2011 was $0.14 per share. And adjusted net income for the second quarter of 2010 was $0.35 per share. For the remainder of this discussion, all references to results and costs will be an adjusted basis, excluding these items.

On slide eight, we have broken down our adjusted results between our US and International operations. During the second quarter of 2011, we generated adjusted earnings of $0.09 per share in the US, on revenues of $93.9 million.

Our US revenues during the second quarter included $1 million of revenue from one month's worth of activity, post acquisition, from Ross Smith. This represented approximately 80% of the total Ross Smith revenue recognized during June, with the remaining $300,000 reflected in our Canadian results.

Our US pre-tax margin in the second quarter was 7.2%, down from 13.5% in the first quarter, due primarily to the reduction in our rate per share from the shift in the client mix of our trading volume, which I will discuss a little later.

Our combined international businesses generated adjusted net income of $0.05 per share on revenues of $48.7 million.

Our international pre-tax margin was 8% in the second quarter, up from 7.2% in the first quarter of 2011 and up from 6.5% in the second quarter of 2010, due to the continued improvement of our Asia-Pacific operations.

Our consolidated effective tax rate for the second quarter was 45.2%, compared to 44.3% in the first quarter of 2011 and 43.5% in the second quarter of 2010.

On slide nine, you can see that our adjusted US expenses were flat, sequentially, at $87.1 million, even with the inclusion of $900,000 of expenses in the US during the month of June from our new energy research operations and an additional $500,000 of transaction processing costs associated with an increase in market-on-close executions from our index-based clients.

An increase in adjusted US expenses over the $84.1 million during the second quarter of 2010 primarily reflects the impact of expenses related to our research operations, totaling $7.8 million, inclusive of Energy Research. This is offset, in part, by our continuing efforts to manage costs.

The $7.8 million from our research operations included $900,000 of stock-based compensation expense associated with retentive awards granted to the management teams, $300,000 for amortizing intangibles recorded as part of the purchase price allocations, and $1.3 million of data and telecom costs.

Our US compensation ratio increased sequentially to 39.3% from 38.1%, due to the revenue decline, as the absolute dollar amount of compensation was down by $1.4 million.

The increase in transaction processing costs, as a percentage of revenue, to 14.3%, was largely attributable to our trading mix.

On slide 10, we have provided a summary of our international results. As compared to the first quarter of 2011, revenues were down $900,000 due to reduced market activity in Europe and Canada, which offset a $1 million positive impact from foreign currency translations, $300,000 of new research revenue in Canada, and a $1 million in Asia-Pacific, to a quarterly record revenue amount of $10.4 million.

Overall adjusted international expenses were down $1.1 million, sequentially, even with a $1 million increase from foreign currency effects and $200,000 of new research costs in Canada, due to reduced compensation and reduced transaction processing costs.

The compensation ratio for our combined international operations was 38.6% compared to 38.7% in the first quarter and down from 40% in the second quarter of 2010.

Combined international transactional processing costs during the quarter as percentage of revenue were 19.8%, compared to 20.3% in the first quarter and 22.5% in the second quarter of 2010, due to our efforts across all the international regions to better manage its expense.

On the next slide, we tracked the performance of our foreign segments over the past five quarters. As compared to the first quarter, our pre-tax profits were comparable in Canada and Europe, as efforts to manage costs offset revenue declines, and our pre-tax loss was reduced by nearly 20% in APAC due to the revenue improvement.

On slide 12, we have presented our US volume and rate capture statistics. Our total average daily executed volume was essentially flat in the second quarter as compared to the first quarter, while the combined average daily market volume of NYSE and NASDAQ listed securities was down 11%. Although the sell-side volume mix was comparable to the first quarter at approximately 35% of total shares traded, within our institutional client base we saw a larger portion of the volume come from lower-priced, DMA and market-on-close trades from index and quantitative fund managers.

Due to this shift, we saw a 4.4 mil sequential reduction in our overall revenue capture rate per share to 50.9 mils. A seasonal increase in our market-on-close activity is common for us in the second quarter, due to activities associated with the MSCI, Russell and S&P rebalances.

The 10.5 mil rate reduction from the second quarter of 2010 is largely attributable to the year-over-year growth of our sell-side volume, which only represented approximately 20% of our volume in the second quarter of 2010. The growth in volume from the sell-side since the second quarter of 2010 accounted for almost 70% of the year-over-year reduction in the average rate per share.

During the second quarter, we repurchased 340,000 shares for a total of $5.2 million. As Bob mentioned earlier, this activity was limited during the quarter by the news that was announced on July 12th. Having said that, our year-to-date stock repurchases of $17.8 million represent 116% of our year-to-date adjusted net income. We now have 1.9 million shares available for repurchase under approved authorizations.

Our current guidance on future stock repurchase activity is consistent with our prior guidance in that we do not feel the need to build additional excess cash and we are comfortable returning our current level of operating earnings and cash flow to stockholder via repurchases. Our capital structure is an area we continue to review as a management team and together with our Board of Directors.

We ended the quarter with $268.8 million of cash and cash equivalents on the balance sheet, essentially flat from March 31st, primarily reflecting the net effects of cash used over and above the new financing to acquire Ross Smith and the build-up of compensation accruals. At June 30th, we had cash of $30 million in excess of the amount needed to support our global regulatory capital needs. This is net of the current amount due on long-term debt and severance and other compensation liabilities.

Since the beginning of 2010, we have reduced the amount of capital in our regulated subsidiaries by nearly $100 million, due primarily to the $150 million debt facility we established in the US for our clearing operations and the closing of our on-shore Japanese operations. We have redeployed this capital, along with our operating cash flow, to repurchase $68 million of our stock, repay $46 million in debt and invest $66 million in research acquisitions, net of new financing.

On a forward-looking basis, I would like to make the following observations - the cost reduction plan established at the end of the second quarter was put in place to improve margins and enhance stockholder returns. We expect this plan to reduce costs by more than $20 million in 2012.

On slide 13, we have detailed the components of the expected savings by region. As you can see, the majority of the expected savings are compensation-related due to reduction of approximately 100 employees. The US is, by far, the largest region impacted. However, we have also focused our efforts on the European region, given the challenges faced there.

These savings will phase-in over the remainder of 2011 with $2.8 million of savings expected in the third quarter and $4.2 million of savings expected in the fourth quarter. The rate of savings from this plan is expected to be in full effect by the beginning of 2012.

As previously announced, we expect the Ross Smith acquisition to be $0.08 to $0.10 per share accretive in 2012. And we expect the impact on our 2011 full year results to be essentially flat, after taking into account the one-time acquisition costs of $0.04 per share. We expect revenues of $4.2 million to $4.6 million from this operation, with associated costs of $3.3 million to $3.6 million.

And with that, I would like to open the call to Q&A. Operator, please open up the lines for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). You do have your first question from the line of Rich Repetto from Sandler O'Neill. Please proceed.

Rich Repetto - *Sandler O'Neill - Analyst*

Good morning, Bob. Good morning, Steve.

Bob Gasser - *Investment Technology Group Inc - CEO*

Hi, Rich, how are you?

Rich Repetto - *Sandler O'Neill - Analyst*

The first question is, the cost cutting -- significant cost cuts to some higher level people and you have gotten in detail about the expense impact and the savings. Do you expect, given the level of these people and the relationships they had, any revenue impact?

Bob Gasser - *Investment Technology Group Inc - CEO*

No, Rich, I think we -- within our sales and trading business in the US, yes, there were a number of senior level folks that were affected. Obviously, there are some touchpoints there with clients that we have acted very quickly to fill any gaps. I personally made, as you can imagine, a lot of outbound calls and made sure that clients were tucked in and the folks that were going to be taking over were engaged very quickly. It was really a -- from the perspective of our US sales and trading business, it was very senior-centric. Not many client-facing folks, and by that I mean daily client-facing folks, were affected as part of the overall reduction in force.

Rich Repetto - *Sandler O'Neill - Analyst*

Okay. Steve, you disclosed that 20% of 2Q 2010 US volume were from the sell-side. Could you give the comparable number in 2Q 2011?

Steve Vigliotti - *Investment Technology Group Inc - CFO*

Yes, I think I did in my remarks as well, it was approximately 35%, which was consistent with the first quarter.

Rich Repetto - *Sandler O'Neill - Analyst*

My last question, Bob, I guess there are some proposed regulations in Canada on dark pools. I just want to see how -- I am sure you are aware of it --what type of impact might this have on your business? And -- go ahead.

Bob Gasser - *Investment Technology Group Inc - CEO*

TRI-ACT, clearly, is a nice business for us in Canada. It is not a hugely material contributor to the bottom line up there. It is a nice strategic asset to have. Obviously, we are watching the event -- the regulatory movement very closely, just as we have in Europe and the US. We have some great capabilities there, in terms of our market structure, research -- obviously, Jamie Selway is a big part of that, but Doug Clark, locally, in Toronto, is a great resource for us. And Nick and the team are very actively engaged with the regulators, as well. We will see where things take us. But at the present time, I don't think that it'll have a significant material impact in the most -- even in the most draconian outcome.

Rich Repetto - *Sandler O'Neill - Analyst*

Got it. Okay, thank you.

Bob Gasser - *Investment Technology Group Inc - CEO*

Thank you.

Operator

Your next question comes from the line of Ken Worthington from JP Morgan. Please proceed.

Ken Worthington - *JP Morgan - Analyst*

Hi, good morning. Bob, in your prepared remarks, you talked about the balance approach to capital deployment between near term and the long term. Has the decline in the stock increased the appetite to buyback? Let me explain; if the stock were $15, I'd expect it to slow, given it to $12, does it accelerate a buyback?

Bob Gasser - *Investment Technology Group Inc - CEO*

Obviously, it is more attractive than it was at $15 or $16 for -- whatever our average price was for the quarter. As Steve alluded to, we slowed down, not because of the stock price, we slowed down because we had advice from counsel that, given -- when we recognized we were going to take the write-down and make a material reduction in force, and we were going to have all of the disclosures, we made a conscious decision, in partnership with our counsel, to slow down the repurchase. That was not at all a comment on the valuation of the stock, it was a regulatory issue that we felt we needed to comply with.

So I think that, going forward, my remarks are intended to just address the financial flexibility that we need to maintain. We collaborate with our Board of Directors at every single meeting on the capital structure. This is not something that is an issue that is foreign to any of us. So that having been said, we made two major acquisitions. We are working hard to assimilate them and to combine them into one ITG IR offering.

We are in the process of selectively hiring some research sales folks. We're in the process of creating growth opportunities with more sectors under coverage, with more geographies under coverage, with things like corporate access. Those are the things that we are focused on building into those two properties. As a result, I think we have a lot on our plate. The Majestic and Ross Smith assets are extraordinarily unique, very differentiated and they were also very consistent in terms of the prices paid -- consistent with our financial discipline as a firm.

I would say, at this stage in the game, I think folks should look and say, we are going through a gestation phase and stock is very attractive and our capital structure is something that we are constantly reassessing, as I said, in partnership with the Board. I think that is as far as I can go.

Steve Vigliotti - *Investment Technology Group Inc - CFO*

Certainly, Ken, you should take comfort that we, again, affirm our guidance that we don't feel the need to build any additional excess cash. So anything we generate from the business, we are very comfortable putting back to shareholders via repurchases.

Ken Worthington - *JP Morgan - Analyst*

Okay, great. And then Steve, for you; as I look at the cash in the balance sheet, there is $68.5 million of cash that is restricted and segregated. How much of that is actually ITG cash?

Steve Vigliotti - *Investment Technology Group Inc - CFO*

Well, it is cash that we have -- it is all our cash, but it is required to be held --

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Ken Worthington - *JP Morgan - Analyst*

There is no client cash in there or anything? It is all yours?

Steve Vigliotti - *Investment Technology Group Inc - CFO*

Some of that relates to client -- CSA commissions that we have collected, somewhere less than $5 million.

Ken Worthington - *JP Morgan - Analyst*

Perfect. Then the Canadian business, this may be due to Ross Smith, but the revenue was down for the quarter and pre-tax income was up, if I read that correctly. What were the dynamics there?

Bob Gasser - *Investment Technology Group Inc - CEO*

I think those guys are doing a really good job of managing transaction processing costs. And as you know, going back a year and a half now, that was a key area of focus for those guys and they are getting better and better. That's a key theme for all of our businesses. Every region did better on the TP line, with the exception of the US, which came under some pressure as a result of that big MOC index rebalancing type of activity.

In Canada, we feel really good about the operating discipline that those guys have. And I think the research addition is going to be, I think, a great revenue synergy for those guys. They are out and hitting the ground very hard with, I think it was 24 Canadian accounts that were assimilated as part of the Ross Smith offering. I think there is fantastic opportunity to market that product to a broader group of Canadian institutions. Obviously, a market that is very, very focused on the natural resources and energy more specifically.

Ken Worthington - *JP Morgan - Analyst*

Thank you very much.

Operator

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

Niamh Alexander - *KBW - Analyst*

Hey good morning, thanks for taking my questions. Can I touch on the acquisitions -- and you're getting a lot of questions on your uses of cash and maybe down here, should you be buying back more stock, basically? Is the priority still acquisitions? Does it have to be more accretive than buying back your stock? Are you done with deals for now?

Bob Gasser - *Investment Technology Group Inc - CEO*

I wouldn't say -- I really would be hard-pressed to say never. I guess the point I was trying to make earlier, Niamh, is that Majestic and Ross Smith were two very unique assets that --and in terms of the prices paid, also, were very consistent with our financial discipline. So we would be looking for something, obviously, that is very significantly accretive, in light of where our stock is trading today.

All of that having been said, we have a lot on our plate, in terms of bringing these two assets into the ITG IR offering and assimilating them into our execution capabilities now in North America. We have a lot of work to do to, not only execute to our plan, but to hopefully exceed it. And that is really our focus at this stage of the game. I don't want to say never. I would just say there is really nothing on the radar screen presently to lead me to say we are going to jump right into another acquisition.

Niamh Alexander - *KBW - Analyst*

That's fair enough. Thanks, Bob. If I could go back to the rate card -- and it's very helpful to get the extra information on the spread business, thank you. But we are still seeing fund flows in the industry are continuing to deteriorate and redemptions are growing, not shrinking. How do you get comfortable that you could revert back to higher a rate cards -- if activity ever normalizes over the next few years -- or should we think about the spread business continuing to grow at this pace and therein, maybe the rate card continuing to shrink.

Bob Gasser - *Investment Technology Group Inc - CEO*

I would -- certainly the last thing in the world I want to do is offer a prognostication about domestic fund flows at this stage of the game. This would be a quadruple dip. We've had a lot of false positive indicators. All those things factor into our decision-making, which is -- and I've said it time and time again, hope is not a strategy. We are trying to be proactive and get out in front of it by sharpening our cost focus.

While I am hopeful that things will revert to some semblance of the mean, that is not the way we are operating this firm. I think you have seen, in the past, that our expense discipline is core to what we are dealing throughout what has been a very secular change in this business. And it will continue to be. We have a very solid plan for addressing that challenge.

Steve Vigliotti - *Investment Technology Group Inc - CFO*

Niamh, part of the purposes of the enhanced segmentation we provided is to give you all comfort that the rate card from the active managers that we primarily cover is relatively stable. And that when activity returns from them, that we should expect those level of rates to get back to where they were.

Bob Gasser - *Investment Technology Group Inc - CEO*

Those 135 institutions that are paying us for the research product that I mentioned in our prepared remarks are doing so at a rate that is three-x the average. And we expect that to continue to move higher. That is a very important data point for us. That is the -- in many ways, the validation that we needed to continue down this path, from a strategic perspective. I can't tell you when things are going to recover. But I can tell you that we are doing everything in our power to create as much operating leverage as we possibly can for that day.

Steve Vigliotti - *Investment Technology Group Inc - CFO*

Right. And during this period -- when this activity from -- long onlys are down, and while we have the infrastructure in place, from our perspective, it makes sense to continue to leverage that infrastructure with these additional flows that we're bringing in.

Niamh Alexander - *KBW - Analyst*

Thank you. I appreciate the color in explaining. While you are talking about the strategic direction, there, given that the environment has lasted so long and it seems to be deteriorating, are all strategic options on the table right now? Or is the focus very much driving additional revenue and converting the research platform -- are incoming calls increasing? Or anything like that?

Bob Gasser - *Investment Technology Group Inc - CEO*

I think it-- the focus is on operating the business. Anything that happens outside of that, obviously, we will do what is right, from a fiduciary perspective. But the focus is on operating our company. That is what Steve and myself and the management team -- that's our sole focus, is making sure we are well-prepared for any environment. And quite frankly, I feel very confident in our ability to navigate our way through what has now been a -- and can only be described as a secular change in our business.

Niamh Alexander - *KBW - Analyst*

Fair enough. Thank you.

Operator

Your next question comes from the line of Chris Allen from Evercore. Please proceed.

Chris Allen - *Evercore - Analyst*

Hey, guys. I want to touch on -- Bob, you mentioned looking at strategic options relative to -- you inferred -- relative to the accretion that you get from a stock buyback. I'm just wondering what kind of hurdle would you need to see? And has there been given any thought to levering up the balance sheet a little bit to allow more flexibility in the buyback?

Bob Gasser - *Investment Technology Group Inc - CEO*

You know what, Chris? I would say there is always a discussion around the capital structure. There is always discussion around the payout of our operating earnings. As Steve alluded to in his remarks, we are committed to continuing to do exactly as we have done, which is to payout a significant premium of those operating earnings to the stock repurchase plan. That is not going to change.

There is absolutely a fairly high bar that is raised every time, by the Board, when we bring them something like a Ross Smith or a Majestic. You can absolutely take it to the bank that the return on our own equity is a big deal. So it has got to be very compelling. We have been very disciplined, in terms of our prices paid for these two properties. They were both interesting opportunities from that perspective. In that they had reached the stage where there some founders who were selling. And in Majestic, there was a broad group of private equity investors that had reached the terminal stage. All those things made these opportunities very, very compelling for us.

Chris Allen - *Evercore - Analyst*

Thank you.

Operator

Our next question comes from the line of Michael Wong from Morningstar. Please proceed.

Michael Wong - *Morningstar - Analyst*

Good morning, guys. We have been hearing news about possibly increased competition in clearing in Europe. Can you talk about how much of your European transactions costs are related to clearing?

Bob Gasser - *Investment Technology Group Inc - CEO*

Steve will give you that data.

Steve Vigliotti - *Investment Technology Group Inc - CFO*

Give me one second.

Bob Gasser - *Investment Technology Group Inc - CEO*

I would say that -- just as Steve retrieves that for us -- I would say that it's embedded in that transaction processing line. And in addition to the clearing, one of the things the European guys have done a fantastic job with has been the internalization of our order flow. Obviously, when you internalize, you avoid all these costs and these clearing costs of going to these other outside venues.

Our Dark liquidity market share has increased there, as we said in our prepared remarks, which is very, very positive. So it has a double effect. It not only generates more revenue for us but it helps us on the bottom line, in terms of being able to internalize that as opposed to routing it out and clearing it in another venue.

Steve Vigliotti - *Investment Technology Group Inc - CFO*

Yes, Michael, slightly less than half of the transaction processing line in Europe relates to clearing to settlement.

Michael Wong - *Morningstar - Analyst*

Thank you. In terms of your research clients, I believe you said you maybe transformed 80 of those Majestic clients that didn't have a trading relationship with ITG -- you transformed 40 of them so far. What is the holdup with the rest of them? In terms of research revenue, when you transform them into a trading client, is it that they change from, more or less, the revenue that they were formerly paying as a subscription revenue into a commission revenue? And it is, at the beginning, revenue neutral? Or are those truly incremental trading dollars that have not just been transferred from subscription into commission?

Bob Gasser - *Investment Technology Group Inc - CEO*

We only agree to bundle, obviously, when we see an opportunity to create leverage on the revenue side. We would never agree to -- for instance, if you had a $250,000 obligation to Ross Smith, we would never agree to $250,000. We would incrementally add execution revenue on top of that. It is a scattergram in terms of how that all works out. And it is something we track very, very closely, as you might expect.

There were 80 new accounts we acquired with Majestic and 60 with Ross Smith. We are up to approximately 40 -- of converting those clients, and this is primarily Majestic at this stage of the game, converting those clients over to ITG execution. It takes time to establish trading relationships, connectivity, desk-top platform, algo platform, all those things are things that take time. And that is one of the reasons we are, in addition to looking at some research sales folks, we are also very much in the hunt for experienced sales traders, as well. We clearly have a pretty big list of accounts that we want to convert into the full package.

Michael Wong - *Morningstar - Analyst*

Just any thoughts on if the Maple/TMX Group merger goes through, if there is any material effect on your Canadian business?

Bob Gasser - *Investment Technology Group Inc - CEO*

I don't foresee, in talking with our guys up there -- we are a bystander and we are watching from the cheap seats, at this stage of the game. They haven't brought anything to me that would cause concern, in terms of transaction processing or margin -- potential margin pressure.

Michael Wong - *Morningstar - Analyst*

Thank you for taking my questions.

Bob Gasser - *Investment Technology Group Inc - CEO*

Thank you.

Michael Wong - *Morningstar - Analyst*

And I show no more questions at this time. I would like to turn it back to Mr. Gasser for closing remarks.

Bob Gasser - *Investment Technology Group Inc - CEO*

I appreciate you joining us today for our Q2 2011 earnings call. And we look forward to speaking with you in October. Thank you.

Operator

Ladies and gentlemen, that concludes today's presentation. We thank you for your participation. You may now disconnect. Have a great day.