



February 26, 2004

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Concept Release on Measures to Improve Disclosure of Mutual
Fund Transaction Costs (34-48952; File No. S7-29-03)

Dear Mr. Katz:

ITG Inc. (“ITG”) is pleased to present its views on the above-referenced Concept Release issued by the Securities and Exchange Commission (“SEC” or “Commission”) on issues related to the disclosure of transaction costs by mutual funds (“Concept Release”).¹ ITG is registered with the Commission as a broker-dealer under Section 15(a) of the Securities Exchange Act of 1934 (“Exchange Act”). ITG was established, among other things, to operate the Portfolio System for Institutional Trading (“POSIT”). POSIT is an automated equity trading/crossing system that is capable of matching either single stocks or entire portfolios of stock on a confidential basis. Our clients consist of over 500 institutions, including investment advisors, mutual funds, corporate and government pension plans, insurance companies, broker-dealers and trust departments.

As a leading provider of technology-based equity-trading services and transaction cost research to institutional investors and brokers, ITG helps our clients access liquidity,

¹ 68 Fed. Reg. 74820 (December 24, 2003); Securities Exchange Act Release No. 48952 (December 18, 2003). The Concept Release uses the terms “mutual funds” and “funds” as an apparent substitute for the term “investment company,” which is defined in Investment Company Act (“ICA”) Section 3(a)(1). *See, e.g.*, 68 Fed. Reg. 74820, 74820 (Commission considering alternatives “deigned to improve the information that mutual funds disclose ...”) For purposes of this letter we also have used these terms as a substitute for the term investment company (we have capitalized “Fund”) and intend that they have the same meaning they are accorded in the Concept Release.

execute trades more efficiently, and make better trading decisions. ITG is committed to the principles of best execution, as an integral part of its own trading operations for 18 years, and as illustrated through the rigorous pre-trade and post-trade cost analysis services we routinely conduct on behalf of our clients. Our premier post-trade transactions cost product, TCA², is used by approximately 100 institutional clients in the U.S. and 25 institutions globally. ITG also offers ITG ACE, an agency cost estimator that provides pre-trade cost analysis as well as the ability to handicap trades for relative and absolute trade difficulty.

ITG shares many of the concerns expressed in the Concept Release regarding enhancing disclosure of certain implicit and explicit transaction costs borne by mutual funds. In particular, we agree with the Commission that implicit costs can overwhelm other transaction costs and that there is no generally agreed-upon method to calculate comprehensively securities transactions costs.² However, ITG believes that best execution is a process, not a price, and undue focus on certain implicit costs could dilute this important tenet of Commission policy. Moreover, ITG is concerned that SEC efforts to standardize measures of transaction cost disclosure could affect trading of Fund investment advisers to achieve the lowest standardized cost for disclosure purposes rather than focus on other objectives that could benefit Fund shareholders.

ITG also believes that inviting investors to compare implicit costs reported by a diverse group of Funds could result in investors being seriously misled regarding the relative costs associated with a Fund achieving a particular return and likely would result in distortions in how Funds implemented, and reported the costs associated with, various trading strategies. We also disagree with certain commentators who believe that it would be beneficial for Funds to provide certain rough or “ballpark” cost estimates. Rather than require disclosure of standardized measures of costs or rough cost estimates, ITG supports requiring Funds to disclose what the Commission has termed “gross” returns in addition to the standardized returns that are today disclosed. Additionally, we believe that Fund directors³ should be required to consider a Fund’s implicit transaction costs annually as well as approve the process used to measure, analyze and control these costs. Finally, a Fund should be required to describe in its prospectus its directors’ consideration of Fund transaction costs as well as the process used to calculate these costs.

Disclosure of Certain Costs Could Be Misleading

The Commission is considering various alternatives designed to improve the information that Funds disclose about their portfolio transactions costs. One of the

² Concept Release at 74822 (text accompanying footnote 23, which cites article quoting former ITG Managing Director Ananth Madhavan).

³ We mean the term Fund directors to include trustees of those Funds organized as trusts.

alternatives for which the Commission requests comment is whether Fund commissions should be quantified and disclosed without disclosing any other costs.⁴ ITG believes that quantifying and disclosing commissions alone would mislead investors if they did not understand the qualitative importance of implicit, as well as explicit, costs. The Commission recently acknowledged the difficulties investors face in interpreting such disclosure when it eliminated the requirement that Funds disclose the average commission rate per share, in part, because “these rates were technical information that typical investors are unable to understand.”⁵ Implicit costs are large, and their control is a key element in preserving returns in the marketplace, relative to paper portfolio gains. Measurement and analysis of implicit costs, together with cost-minimizing trading strategies, are essential pieces of the investment puzzle that would be lost if only commission costs were disclosed.

However, ITG does not believe that attempting to quantify and disclose *all* of a Fund’s transactions costs would be useful to investors (assuming it were possible). The Commission rightly recognizes that even a fairly comprehensive measure designed to capture implicit costs such as implementation shortfall would involve the selection of a single common standard from among a wide variety of estimation techniques. The selection of a single measure would result in a standardized metric upon which investors invariably will focus, even if that measure was not the sole means of quantifying costs. In response, Fund investment advisers might distort their trading strategies to reduce these reported costs while increasing costs that are less easily captured. Additionally, we believe that the Commission is correct to be concerned about any uniform cost measurement system being “gamed.” We believe that the Commission should take an approach similar to the approach it has taken in the best execution context and instead focus on laying down enforceable standards relating to the measurement and consideration of Fund transaction costs by a Fund’s investment adviser and directors, rather than seeking a standardization of cost reporting that may put pressure on Fund investment advisers to standardize execution techniques.

Similarly, ITG also does not believe that disclosure of implicit costs by broker-dealers would be useful. Many Fund transactions are “worked” by broker-dealers and the implicit costs associated with these orders again defy the degree of standardization that would be required to enable investors to make meaningful comparisons between Funds based on execution quality information reported by various broker-dealers. Additionally, it is important to remember that the concept of best execution encompasses many factors, some of which are difficult to quantify, but no less important than those that are more

⁴ Concept Release at 74822.

⁵ Concept Release at 74828, footnote 51 (citing Investment Company Act Release No. 23064 (March 13, 1998)). The Commission eliminated this requirement less than three years after it was adopted. Id.

easily measured.⁶ We note that the standards governing a broker's duty to attempt to achieve "best execution" for its customers' orders implicitly acknowledge the inherent difficulty in comprehensively measuring and comparing implicit transaction costs for customers with differing needs.⁷

ITG supports the process of measuring, analyzing, and controlling implicit transaction costs. Disclosing implicit costs, however, necessarily requires that something concrete be disclosed, which in turn implies a degree of standardization, as opposed to the use of general standards. ITG believes that the costs associated with this degree of standardization would outweigh its benefits. Moreover, the Commission appears to believe that standardization is necessary only in the case of "before trade and after trade methods" as opposed to the use of a measure such as implementation shortfall measurement. However, we note that implementation shortfall also requires standardization and that it might be difficult to develop comprehensive definitions of key terms to support the required degree of standardization.

An illustrative example relates to certain ambiguities raised by attempting to define the term "order." If a Fund transmitted an order at 11:00 a.m., added to the order at 11:45 a.m. and received an execution of the entire order at 1:00 p.m., a question would arise as to whether one or two orders were involved. Certain investors might assume that, for purposes of calculating implicit costs, one order had been placed and executed while other investors might assume that two separate orders had been placed and executed. We are concerned that each of the investors in the above example would be forced to use the same method of calculating their implicit costs for purposes of disclosure.

Disclosing "Rough" Cost Estimates Could Be Highly Misleading

In the Concept Release the Commission notes that several commentators have suggested that the SEC suggest "[disclosing a] ... rough estimate of transaction costs, or develop a scheme to categorize these costs."⁸ A rough estimate is *not* better than no estimate at all, and would be confusing and potentially misleading, particularly if the issues raised in the calculation of such costs are not well understood by the Fund shareholders who must evaluate such numbers. Additionally, the calculation of rough estimates again implies that each Fund's costs would be compared to some type of

⁶ See, e.g., Securities Exchange Act Release No. 42450 (February 23, 2000); 65 FR 10577, 10583 (February 28, 2000) ("Price is not the sole factor that brokers consider in fulfilling their duty of best execution with respect to customer orders."); Study V: Best Execution Market 2000: An Examination of Current Equity Market Developments, Division of Market Regulation, United States Securities and Exchange Commission (January 1994)).

⁷ Id.

⁸ Concept Release at 78427, Question 16.

standardized industry measure. For such a comparison to be possible a particular transaction cost measure would need to be developed and universally adopted and ITG believes this would be difficult to do and ultimately counterproductive.

Gross Returns Should Be Disclosed

A useful goal of Fund disclosure policies is to give investors the ability to compare different investment managers on an equivalent basis. ITG does not believe that this is possible today through comparisons of “standardized” returns alone. Although standardized returns do represent the return “that funds generate after fees and expenses”⁹ the only transaction costs separately disclosed in conjunction with the reporting of these returns are explicit transaction costs. The actual amount of the relevant implicit costs is not broken out. Rather than require Funds to attempt to quantify these implicit costs to address this deficiency ITG supports mandating the disclosure of the returns that Funds generate prior to all identifiable costs (“gross returns”). As the Commission suggests in the Concept Release, gross returns could be disclosed “side by side” with standardized returns.¹⁰ ITG agrees with the Commission that “[t]he disclosure of gross returns would also allow investors to compare the performance of investment managers on an equivalent basis.”¹¹

As investors, Fund shareholders are interested primarily in the return a Fund has provided on their investment, not the level of implicit transaction costs embedded in the return. As the Commission acknowledges, having access to a Fund’s gross returns and standardized returns would allow investors to determine how much of the portfolio return they receive on a net basis. We agree that investors also would be able to evaluate the relative efficiency of different investment managers. These comparisons alone could increase competitive pressure in the market for investment management services.

The Commission suggests that another possible approach to improving disclosure of Fund transaction costs would be to require discussion of transaction costs in a Fund’s prospectus.¹² In order to support the disclosure of gross returns (discussed above), and to raise the awareness of the investor with respect to trading costs and best execution more generally, we believe that this type of narrative disclosure is essential. A narrative explanation would avoid the limitations inherent in any standardized numerical disclosure and could provide context regarding the costs incurred by the Fund. Further, such a narrative should appear in the Fund prospectus, meriting the full attention of the investor,

⁹ Concept Release, text accompanying footnote 52.

¹⁰ Concept Release at 74828.

¹¹ Id.

¹² Concept Release at 74826.

as opposed to being a part of purely technical documentation pertaining to Fund operations (e.g., a Fund's Statement of Additional Information).

Fund Directors Should Be Required to Consider Implicit Costs

The Commission indicates that a Fund's portfolio transaction costs can be substantial and should be a significant issue to be considered by a Fund's directors. ITG agrees with this assessment.¹³ Fund directors have a greater degree of sophistication than most Fund shareholders and would be capable of placing into the proper context reports from the management of a Fund's investment adviser relating to the implicit and explicit transaction costs incurred in implementing a Fund's investment strategy. However, the Commission notes that "transactions costs incurred by a mutual fund are also generally reviewed by the fund's board of directors ..."¹⁴ The Commission makes this assumption because Section 15(c) of the Investment Company Act requires Fund directors "to request and review such information as may reasonably be necessary to evaluate the terms of the advisory contract between the adviser and the fund."¹⁵ Despite this legal framework, ITG is less confident than the Commission that Fund directors consider carefully the implicit transaction costs borne by Funds. Interestingly, the discussion of this issue in the Concept Release focuses almost exclusively on commissions and fees. Similarly, we believe that, today, consideration by Fund directors of Fund transaction costs (to the extent they are considered) also focuses primarily on commissions and fees.

Further, we believe that existing requirements for Fund director review of transaction costs are not adequate. Fund directors should be required to consider implicit Fund transaction costs. In fulfilling this requirement, a Fund director should be entitled to rely upon representations made by officers of a Fund's investment adviser that they have followed a process for measuring and analyzing the transaction costs borne by the Fund that has been approved by the Fund's directors. Consistent with their oversight role as directors, Fund directors should be required to exercise oversight of this process without being required to micromanage it. Being able to rely on representations from officers of a Fund's investment adviser would facilitate Fund director oversight of this area.

Specifically, we recommend that the Commission require that: 1) Fund directors approve a process for measuring, analyzing and controlling a Fund's implicit transaction costs, and 2) one or more officers of a Fund's investment adviser be required to certify in writing to the Fund's directors that the implicit transaction costs reported to Fund

¹³ Id.

¹⁴ Id.

¹⁵ Id.

directors were calculated in accordance with the process approved by Fund directors. An example of this type of approach is found in the Commission's recent adoption of ICA Rule 38a-1, which requires Fund boards to adopt written policies and procedures reasonably designed to prevent the Fund from violating the federal securities laws and to approve the policies and procedures of Fund service providers.¹⁶ Fund directors may satisfy this obligation by reviewing summaries of compliance programs prepared by a Fund's chief compliance officer or other persons familiar with the relevant compliance programs.¹⁷ We envision a similar approach with respect to a Fund's implementation of a program to measure and consider a Fund's implicit and explicit transaction costs except that one or more officers of a Fund's investment adviser would be required to provide Fund directors with a written certification as outlined above.

Separately, the Commission also has asked several questions with respect to disclosure made to Fund directors relating to the internal allocation of a Fund's uses of commissions.¹⁸ In particular, the Commission asks whether Fund investment advisers should provide to Fund directors information regarding the allocation of a Fund's commissions that are used to pay for various kinds of research. We believe that this is a good idea. Additionally, we believe that Fund directors should be able to identify, for example, research Funds being allocated to the measurement, analysis, and control of transaction costs. Commissions used to pay for this type of research should be allocated separately from commission used to pay for research produced by underwriters or analysts concentrating on company fundamentals. Armed with this information, Fund directors would be better equipped to exercise some judgment regarding the utility of various research purchased with commissions generated by trading on behalf of Funds. That is, Fund directors would themselves be capable of determining whether the savings achieved through the measurement, analysis, and control of transaction justifies the commission dollars used to pay for the research used to undertake this analysis. In ITG's experience the savings experienced by investors paying for such research significantly exceeds its cost.

No Need for Aggregate Collection of Statistics

The Commission notes that it may be difficult for Fund directors to assess execution performance statistics without comparing them to other Funds' statistics. While we believe that absolute performance goals should be set and achieved pursuant to best execution guidelines, we acknowledge that additional information relating to the transaction costs incurred by other Funds' might be useful. We disagree, however, with the suggestion that the Commission or other independent body collect statistics from similar funds and make available aggregate statistics for comparison purposes. Implied

¹⁶ ICA Release No. 26299 (December 17, 2003).

¹⁷ Id at text accompanying footnote 33.

¹⁸ Concept Release at 74828, Question 33.

in this suggestion once again is the notion that standardization of the reporting of transaction costs is both feasible and desirable. We disagree with this idea for the reasons set forth herein. Moreover, third-party providers already deliver services that may be customized to the needs of any Fund board or other interested organization.¹⁹

Again, ITG appreciates the opportunity to comment on the important issues raised in the Concept Release. We would be pleased to discuss any of our comments set forth herein with the Commission or its staff.

Very truly yours,

Ian Domowitz
Managing Director and
Head of Analytical Products and Research

cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
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¹⁹ See, e.g. Concept Release at 74823, footnote 32.