MarketWatch

IEX CEO Katsuyama stands firm on exchange's fee-only model

By Francine McKenna
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IEX Group, Inc., the exchange portrayed as an investor's hero in Michael Lewis' book Flash Boys, won its protracted battle to become a full-fledged stock exchange. Now CEO Brad Katsuyama wants to win the war, making money his own way while bringing a level trading playing field to retail investors.

That won't be easy. The Equities LiquidityMatrix report for May 2016 from research firm Tabb Group says industry average daily volume was 7.0 billion shares, the highest volume seen in May since 2012 and a 13% increase year-over-year. However, on Monday Goldman Sachs slashed its 2016 estimate of U.S. demand for equities by nearly half, citing a weaker appetite for stocks among retail investors.

The other major exchanges, Intercontinental Exchange Inc's ICE, -0.50% New York Stock Exchange, BATS Global Markets, and Nasdaq Inc. NDAQ, -0.19% together run 10 of the now 13 stock exchanges. In contrast to IEX, they earn substantial revenue by serving high-speed traders, charging them more for faster connectivity and proprietary data and paying retail brokers rebates to attract more trading volume.

In an interview on Monday with MarketWatch, IEX CEO Brad Katsuyama said he is committed to continuing to make the majority of the company's revenue from trading fees.

Katsuyama says market share for the major exchange groups is static, because they don't differentiate on service and, therefore, have to pay as much in rebates as legally possible for the trading volume they get.

"We don't pay for orders so we have to earn the business in other ways. We are a service provider. We have to provide the best service to investors," he said.

Katsuyama continued to rule out the other common exchange revenue sources—selling market data and charging for faster connectivity. IEX delays its proprietary market data feed uniformly to all IEX users. "Our market data feed is free. Some have suggested we charge at cost for data. It's not part of the plan."

In its application IEX stated its intent not to pursue "maker-taker" rebate pricing and instead offer only flat transaction fees. The approval of IEX's application, tied up for 270 days was in large part driven by controversy over its proposed trading system—specifically, its "Point-of-Presence" or POP and "coil" infrastructure, more commonly referred to as IEX's "speed bump." There was also quite a bit of comment for detractors about the way IEX originally proposed to provide outbound trade routing services through its affiliated routing broker-dealer.

In the end IEX revised its proposal with regard to the outbound routing of trades to its broker-dealer, and the SEC as well as critics were satisfied. And the SEC noted in its approval that speed bump applies to all IEX users equally, and cannot be bypassed, for a fee or otherwise.

IEX also plans to wait on getting into the listings business, another fee generator for the traditional exchanges. The majority of its regulatory functions will be outsourced to Finra, the industry regulator, an approach also used by BATS Global Markets BATS, -2.73% Taking on listings would require additional regulatory compliance activities.

A spokesman for Finra did not respond immediately to a request for comment on its pending contract with IEX.

IEX is running a lean operation right now, Katsuyama explained, with about 70 full-time employees. “We plan to add about 10-15 more leading up to the launch,” said Katsuyama, which is expected to be sometime in mid-August. If anyone doubts IEX can succeed with this model, Katsuyama says it’s already doing that. “We been profitable for the last year,” he said.

The SEC’s approval of IEX’s speed bump did not thrill its biggest critics. One, ICE CEO Jeff Sprecher, called IEX’s approach “unfair” and “un-American.” Another New York Stock Exchange comment letter said it agreed with other commenters such as John Nagle of Citadel and Charles M. Jones, a professor of finance and economics at Columbia University Business School, who wrote that it “would lead to less transparent markets, wider spreads and higher costs for investors.”

A spokeswoman for ICE’s New York Stock Exchange declined to comment on the IEX approval.

In response to criticisms that the IEX speed bump would negatively affect market transparency, degrade the national best bid or offer price or NBBO, or distort price discovery, the SEC noted that traders already experience very short delays in receiving updates to displayed quotations, because of the distances between data centers and the variations in technology used by market participants. The IEX speed bump delay is “de minimis”, not significantly better or worse than other delays for other intentional and non-intentional reasons.

That means all market participants must now route a trade to IEX for execution if it displays the best bid and best offer for that stock, not “trade through” at the current broker or exchange.

Citadel, probably the most outspoken critic of the IEX application, is still not convinced. The firm issued a statement through a spokesman:

“We support the earlier improvement made to the IEX application to remove the advantage given to its affiliated routing broker dealer. However, while necessary, that change was not sufficient. Today’s decision will test and potentially reverse the gains in fairness, efficiency and transparency that have been made to our markets over the last decade. We must be vigilant to identify unintended consequences, and firm in our commitment to equitable and consistent treatment for all investors.”

Nasdaq, which at one point threatened to sue the SEC if the IEX application was approved, had only this to say through a spokesman after the news of the approval broke late Friday: “We are evaluating the SEC’s decision and assessing all options to ensure the best outcome for the U.S. equity markets and all of its participants.”

When Katsuyama was asked during the interview on Monday whether he was worried that all of the exchanges would now be able to get along, work together on the ongoing initiatives to protect investors and the markets without rancor, Katsuyama sighed.

“There’s an element of professionalism we hope everyone can abide by going forward,” he said.

Supporters of IEX’s exchange aspirations were ecstatic after the decision was announced. **Joe Saluzzi**, co-founder and co-head of equity trading for **Themis Trading**, told MarketWatch that the SEC’s decision was precedent-setting and important.

“We believe IEX’s business model, not dependent on selling fast access and data feeds to the highest bidder, is sustainable and in the best interests of long-term investors,” said **Saluzzi**, “and we applaud the SEC for granting IEX’s exchange application approval, amidst intense lobbying. This is clearly a win for IEX, but it is a bigger win for investors.”

Eric Hunsader, founder and CEO of Nanex LLC, a frequent critic of high-frequency trading and a supporter of the IEX application, said that the SEC's approval of the IEX application unconditionally was a "complete victory."

In a statement issued after the SEC issued the official announcement, Katsuyama said IEX was "grateful and humbled by the support we've received" from the investor community. Without it he said the firm may have faced a different result. The SEC received hundreds of comment letters including letters of support from institutional investors and market players such as the California State Teachers' Retirement System, the world's largest pension fund for teachers, Goldman Sachs Group Inc. GS, +0.40% and T Rowe Price TROW, -0.50%

"This is a milestone for all of those who have supported IEX," Katsuyama in a statement after the approval was announced, "and we look forward to becoming a stock exchange, which will provide us the opportunity to have an even greater impact on the markets."