

## Wall Street spurns great innovation

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The forthcoming initial public offering of Interactive Brokers Group has attracted less attention than it should from Wall Street, but perhaps that is understandable. IBG, an electronic brokerage and marketmaking firm, is the most automated US securities firm, with the lowest unit costs in the business.

It has been taking share from the rest of the Street for almost 30 years, and is now the 16th largest securities firm in the US, as measured by consolidated capital, according to Institutional Investor. With about 500 employees, IBG executed about 97m trades in 2005. Its equity capital of \$2.6bn has grown at a compound annual growth rate of 24 per cent since December 2000, and it more than \$32bn in total assets. Its controls on those assets are tight enough that, over the past three years, it incurred just \$972,000 in losses on bad customer accounts.

I have known Thomas Peterffy, the chairman and founder of IBG, for about 20 years, dating back to when I worked with a firm that was associated with the market-making side of IBG, Timber Hill. He was then, and still is, the antithesis of the oily Wall Street promoter. He is a brusque, driven, mathematician, who is on a mission to crush transaction costs and take self-serving human intermediaries out of the pricing process.

It figures that he would have chosen the open-auction method for doing IBG's initial offering, using W. R. Hambrecht, the San Francisco investment bank, and E-Trade as co-manager. IBG's \$500m proposed offering of 5 per cent of the equity in the group is more than three times the size of the largest open auction IPO completed so far, which was the \$140.8m issue done in May of last year for Morningstar, the investment research firm.

The open auction method, which is principally sponsored by Hambrecht, takes much of the investment banker's questionable margin out of the IPO process. Typically, investment banks charge 7 per cent for an IPO. Hambrecht and its co-managers charge 4 per cent for an offering under \$100m, 3 per cent for \$101-\$300m, and 2 per cent for one over \$300m.

In a bookbuilding offering, the price is set after the bankers and salespeople consult with their buy-side customers, who, in effect, set the price. Not surprisingly, they like to set a low price. That is why you get those big price rises in the first day or two, frequently followed by gradual declines.

In an open auction, the price is set by customer bids, with the final price being the minimum at which all the shares can be sold. Since the shares are fully priced at issuance, there is no advantage to be had from being a "friend" of the investment bank. IPO flipping, a good business in the 1990s for the connected, does not happen. Neither Hambrecht nor IBG would discuss the Interactive Brokers offering, but Clay Corbus, the co-chief executive of Hambrecht, did give me his pitch for the open auction process.

"You have to look at all the costs to the issuer of an IPO, which is not just the 7 per cent fee. The standard IPO discount is 15-20 per cent, so if you combine that with the underwriting fee, that is a high cost of money. When you see a big jump in the price of an IPO, the underwriters should say they did a great job of screwing the issuers and rewarding their buy side clients."

Joe Mansueto, chief executive of Morningstar, dumped his original investment bank, Morgan Stanley, because they would not do an open auction IPO. "Morgan Stanley told us that we had a complicated story to tell, which is why we needed a bookbuilding process. We didn't think it was that complicated. We were out to sell 8m shares, and we had demand in the range of 35m to 40m shares. I think it's a very scalable process." Mansueto paid just 2 per cent for his IPO since Morgan Stanley had done a lot of the documentation. That saved the company \$7m, or about a third of the last quarter's earnings, compared with the standard 7 per cent. Clay Corbus thinks there are times when a company's story does need more explanation than Morningstar's, which was already well

known to investors.

Open auctions should be attractive for companies with a large, affluent customer base or some other affinity group that would already know the story. Hambrecht introduced the open auction in 1998 towards the end of the last IPO boom. Most innovations on Wall Street are appropriated by competitors quickly, but open auctions are still fairly rare. Maybe that is because they are a way of cutting fees, rather than increasing them.

#### Refco bankruptcy

I have had some inquiries about how the Refco bankruptcy process worked out for the creditors, and for those who bought its IPO just a couple of months before it collapsed in October last year after \$430m in losses were revealed. You would have expected the shareholders to have already been made whole on what they paid, but no, that would presume the underwriters had some sense of shame for how they carried out their due diligence process.

The bankruptcy plan's confirmation hearing is set for the middle of this month. Bondholders should soon get just short of 85 cents on the dollar, assuming the plan is confirmed. The customers with claims on Refco Capital Markets will receive between 85 and 90 cents, with 83 cents right away and the rest depending on recoveries from litigation. The foreign exchange customers should get 45 to 55 cents.

There are still various criminal trials to come in the US and Austria before the Refco story is closed, along with litigation brought by shareholders. "Once, I would like these investment banks to get what they deserve," wrote one reader-Refco shareholder. Their answer is that they continue to deserve 7 per cent of the proceeds for that quality of work.

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