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BI PRIME

Interactive Brokers has upended Wall Street time and again. Its founder explains how causing chaos is key to staying competitive in a cut-throat industry.

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- **Interactive Brokers, the Greenwich, Connecticut-based brokerage, has led the way during several phases of the industry's fiercely competitive war over price and capabilities that's played out in recent months.**
- **Senior leaders from the firm, including chairman Thomas Peterffy, spoke with Business Insider recently about their strategy – and what comes next.**
- **Their products have been replicated time after time in this cut-throat industry, they're quick to note, and they say they are concerned about tipping off competitors with much talk of future plans.**
- **"We are basically computer programmers. We are not experts of finance," he told us in a recent interview. "What we lack in expertise in finance we make up in our technology expertise."**

In the world of discount brokers, moves like product launches and pricing changes can spark major drama.

At 1:19 in the afternoon late last September, Interactive Brokers released a statement about an offering it would roll out the following month: a product featuring unlimited, commission-free trades for US-listed stocks and ETFs.

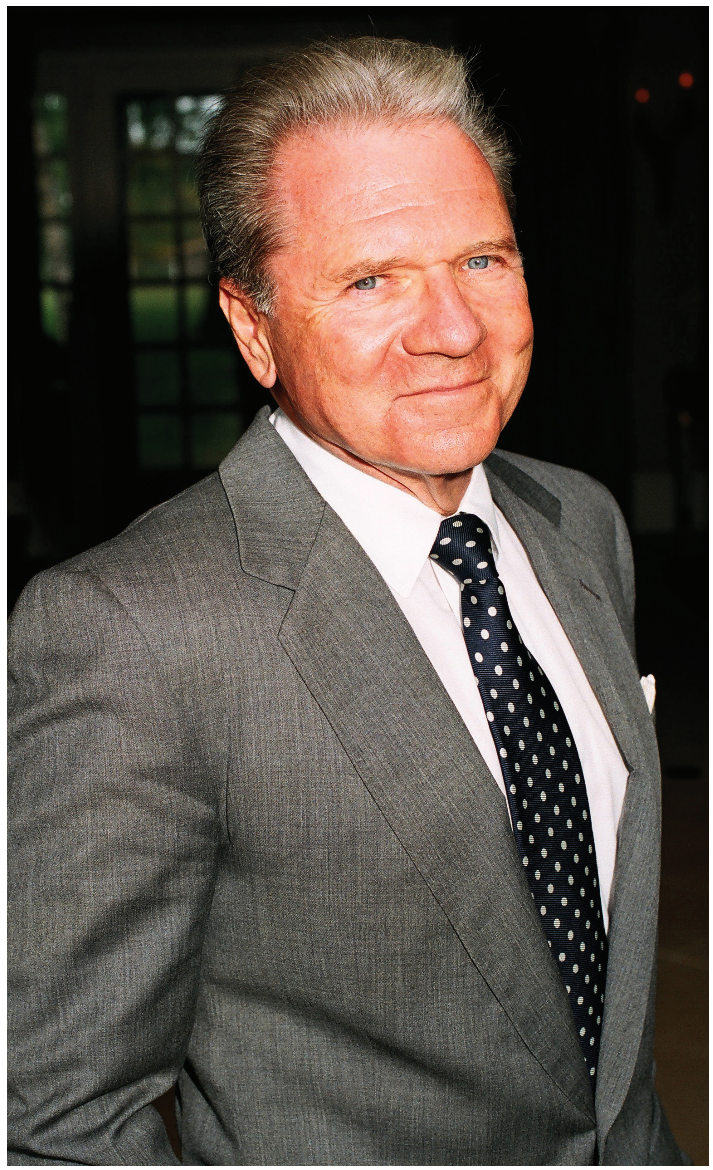
Competitors' shares instantly took a hit. By 1:41, investors sent TD Ameritrade shares down 5%. E-Trade closed out the session with a similar loss. Charles Schwab, which has a bigger share of non-commission revenue than rivals, fell 2%.

"Ha @IBKR just went full @RobinhoodApp on the entire brokerage industry," Meb Faber, the finance blogger and Cambria Investment Management co-founder, tweeted. "Love it."

That was on a Thursday. The following Monday closed out the third quarter.

On Tuesday, Oct. 1, Charles Schwab blasted out a press release from San Francisco before the stock market opened: while publicizing its cofounder's book, the firm also said it would stop asking customers to pay a fee for their trades.

That Tuesday night, TD Ameritrade swooped in with a message from Omaha that it too would get rid of commissions. Its shares plunged 26% that day.



Thomas Petterfy – Suplied by Interactive Brokers

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Twenty-one hours later, E-Trade followed suit. Fidelity did the same the following week.

Then in November, just before Thanksgiving, Charles Schwab said it would buy TD Ameritrade in the largest brokerage deal on record. Executives said it would lead to branch closures and job losses; some registered investment advisers, especially small ones, bristled at the thought of being forced to change custodians.

Entire brokerage, custody, and wealth management worlds were upended in less than two months' time after Interactive Brokers sparked the rapid-fire, industry-wide domino effect.

The $23 billion public company, a third the size of Charles Schwab's market capitalization and 2-½ times larger than E-Trade, had put itself out there as a first-mover – at least among incumbent firms – in offering commission-free trades, a feature of modern finance that a younger set of traders and investors with money on startup brokerage apps has come to see as a given.

It wasn't the first time Interactive Brokers was on the leading edge of an industry trend. It was first among its large rivals when it started offering fractional-share trading last November, and it rolled out a simulated sports-betting offering last July.

"We have been in this business for decades, and everything we've ever done has always been copied," Thomas Peterffy, the co-founder, chairman, and former chief executive of Interactive Brokers, told Business Insider in a recent phone interview. "So you must excuse me, but I cannot tell you what's in the oven."

On the firm's second-quarter earnings call last July, Peterffy had a colorful exchange with an analyst around the simulated sports-betting game it recently announced. It was intended to attract new customers who may not have been familiar with the financial markets, but were "more familiar with the probabilities of spectator sports," the company said.

An analyst asked Peterffy for more detail about the launch. "Your question seems to indicate to me that you haven't tried it," he responded. The analyst said he hadn't.

"If any of you have any questions, I really would suggest that you try it," Peterffy said. "Now, once you try it and you play a few games, make a few bets, you will get to like the platform."

The exchange went on like that for a few more minutes. The next month, ESPN and TD Ameritrade said they were working together on a statistical trends tool for ESPN fantasy players.

The wider brokerage industry used to compete on price, and benefitted from interest in trading single stocks. But passive investment ownership has exploded in popularity.

Customers' changing tastes and standards for what they'll pay for are quickly raising the bar, and that's left Interactive Brokers to try and set itself apart with the technology at the company's core.

Meanwhile, Interactive Brokers and its competitors are under pressure to keep costs low, especially against ultra-low US interest rates that have already eaten into their their bottom lines.

Charles Schwab chief executive highlighted those pressures at an investor presentation earlier this month. While he found incentives like offering cash rewards for opening brokerage accounts to be a "distasteful approach," his firm would have to be willing to match those offers or risk losing business.

We spoke with Interactive Brokers insiders to learn more about the firm, and to try to get hints on what's next.

Changing the guard (sort of)

Interactive Brokers is headquartered in the wealthy Greenwich, Connecticut suburb, a short drive north from New York City. As of this month, it has some 1,600 employees in 24 offices in the US and 14 other countries, including Switzerland, Japan, Hong Kong, and Estonia.

Operations looked much different four decades ago. Peterffy, who is 76, founded the firm in 1977 after moving to the US from Russian-occupied Hungary. At the time, he spoke no English.

He began working as a computer programmer for a company that designed highways, he has told the Motley Fool website. Then he started working for a consulting firm, building out programs for Wall Street brokers that sorted stocks by measures like price-to-earnings and price-to-book ratios.

He took a liking to pricing options, and learned about the market. Peterffy, then in his early 20s, bought a seat on the American Stock Exchange, which is now owned by Intercontinental Exchange. The predecessor to Interactive Brokers, Timber Hill, was formed.

Timber Hill remains a subsidiary of Interactive Brokers, and three years ago sold its US options market-making business to a unit of the hedge fund Two Sigma. Interactive Brokers was officially incorporated in 1993.

"I started it with my savings," Peterffy said. "I grew it into a huge enterprise, and it's the only thing I know. It's what I've done all my life."

The firm has long looked for carving out a niche with savvy investors who had a good handle on trading instruments more complex than a simple stock trade.

Instead of "looking for a mass market in the US, we were looking for sophisticated investors and traders around the world, which is pretty much what we've been about," Steve Sanders, the executive vice president of product development and marketing, said in an interview.

Today, Peterffy is worth $17.8 billion, and is the 69th-richest person in the world, according to the Bloomberg Billionaires Index. Investors and analysts have come to know him for flamboyant commentary, quipping about the industry and community in a way other executives often avoid.

"George Soros is an enigma. He's a very bright man, and I absolutely do not understand why he behaves he way he does. I think he's basically an anarchist," he said of the investor and philanthropist in a CNBC interview.

Peterffy stepped down from his chief executive post last year; he said in a statement in January 2019 that as he got older, he thought a longtime senior employee of the company, Milan Galik, would be better suited to lead.

Galik joined the firm three decades ago, and became president in 2014. He has been a board member since Interactive Brokers' 2007 initial public offering.

But Peterffy, who remains the chairman, is still very much the face of the company. The firm did not make Galik available for an interview for this article, and he was not on the fourth-quarter earnings call held last month.

On the earnings call, an analyst asked Peterffy when he would begin unloading some of his stake in the company. He didn't have an answer. But he would be ready "very soon," he said. "It's an emotional thing."

For the fourth quarter, Interactive Brokers reported $500 million in net revenue and $312 million in pre-tax income, up from $492 million and $309 million a year prior, respectively.

Revenues from trading commissions dropped 18% in that time, while customer accounts rose 15% to 690,000 through December 31.

Tech as a sole strategy

These days, Interactive Brokers is trying to stay ahead with the tech it's always relied on to set itself apart. Peterffy's biggest challenge right now, he said, is ensuring the firm keeps innovating and coming up with new and better options for customers.

"We must be able to come up with ideas that resonate with people," he said, adding that he's "reluctant" to discuss new projects on his roadmap and risk giving competitors a chance to "win the game."

Sanders, the executive vice president who joined the firm nearly 20 years ago, called Interactive Brokers a "technology company that's in the brokerage business" – a mantra and strategy it's doubling down on as competition has only ramped up in the industry.

The majority of the company's employees are programmers, he said.

This month, the firm released what it calls the Bond Scanner, which aims to help traders find the best prices for bonds in a simple way. Users can search the universe of bonds, including Treasuries; for corporate bonds, by industry, or by state, for municipal bonds.

It's also recently rolled out a feature called Fundamentals Explorer, a tool that allows users to parse through an "enormous" set of Refinitiv-sourced data, said Brandon Weislak, a product manager at the firm.

The feature allows users to view company information like balance sheet data, ESG scores, and analysts' ratings, and presents it in the context of historical trends and industry averages, he said in a recent interview in New York.

"There's been a pretty big push within the company to make use of this ESG data and get it out to customers," Weislak said, referring to environmental, social, and governance framework.

He added that its robo-adviser, called Interactive Advisors, has also launched ESG-focused portfolios.

The firm's fractional share offering, which it announced last November, beat Fidelity and trading app Robinhood's offering to the market. And while Charles R. Schwab hinted in a media report four months ago that Schwab, the firm, would allow customers to trade fractions of stocks, it has not yet rolled out an offering.

Interactive Brokers simulated sports-betting offering, first announced last summer, came months before Business Insider first reported that TD Ameritrade was exploring that corner of the market.