

NEWSWEEK

September 22, 2008

Capitalists of the Prairie

A tiny Kansas City start-up now handles 10 percent of all U.S. stock trades. How BATS took on Wall Street to shake up the financial establishment.

By Daniel Gross

It's 9:30 in the morning and the playgrounds of U.S. capitalism are open for business. On the bustling floor of the NYSE in lower Manhattan, brokers call out orders as CNBC anchors Erin Burnett and Mark Haines try to put a brave face on the latest industrial-production numbers. A few miles uptown, in Times Square, the NASDAQ market electronic bell signals the beginning of trading. And in an upscale suburban strip mall outside Kansas City, Mo.—near Latte Land and the Land of Paws pet boutique—business is just getting underway at BATS, America's third largest stock exchange.

Each trading day, as a bell atop the M&I Bank building next door chimes gently, BATS quietly conducts about 25 times the volume of the venerable American Stock Exchange. Here, 1,200 miles from the financial center of the world, a few dozen employees pad around in shorts and polo shirts, amid green cubicles and whiteboards. On any given day, its servers off in New Jersey will process about 12 percent of the trades made in the vast U.S. markets. In less than 36 months, BATS (it stands for Better Alternative Trading System) has evolved from a start-up into an international stock exchange with powerful partners and a nine-figure valuation. "We've really been able to get to critical mass in a very short time," says CEO Joe Ratterman, who, with his blue jeans and shaved head, resembles a dot-com entrepreneur more than the bespoke-suited managers in New York.

BATS is in fact pretty much a technology start-up. Alternative trading systems like BATS—which are also known as ECNs (electronic communication networks)—are digital swap meets for professional stock traders. They began to proliferate in the 1990s, offering cheaper trades and faster execution than powerful, but less nimble, incumbents like the New York Stock Exchange and the NASDAQ. The big shots decided to buy rather than fight; NYSE bought ECN Archipelago in 2000, and NASDAQ bought Inet in 2005.

Once they became subsidiaries of big exchanges, the ECNs had less incentive to compete with them on price. So the consolidation left a gaping hole in the market. Dave Cumming, founder of a Kansas City-based trading firm, and 12 other people—including Ratterman, 41, a veteran of financial-information companies—started BATS with about \$2 million in the summer of 2005. It sounded like a financial version of the movie "300"—a hopelessly undermanned group taking on a giant army. But in the 21st century, you don't have to be a big firm in lower Manhattan to compete on the three factors that made ECNs succeed—speed, cost and service. *Not* being there proved to be an advantage.

Starting from scratch, the engineers—BATS employs few Wharton M.B.A.s and a whole bunch of computer-science graduates from Midwestern universities—built a financial vehicle designed for speed. "The operating system, the network, the hardware was a large science project designed to eke out maximum performance," says Ratterman. Speed was essential, because the target audience for BATS wasn't retail investors placing orders to buy 100 shares of IBM. Rather, it aimed to appeal to hedge funds and other trading operations that execute thousands of trades per day. And for folks who seek to capture the microscopic gains available when, for example, a stock's price moves from 9.23 to 9.25, speed really matters. "In our world, where we're scouring historical data for market patterns, speed is what separates the very good from the great," says Peter Buckley, head of new business at Tower Research Capital, a New York-based hedge fund that uses BATS. (One of the fund's affiliates is an investor in the company.)

Kansas City may not have much of a financial-services industry. But the region's universities and aerospace industry have produced plenty of talented software writers. And because of the opportunities it

afforded, BATS had the pick of the lot and could easily retain them. (On Wall Street, programmers are frequently poached by rivals.) The talent gave BATS a technological edge. In January 2006, when BATS went live, most of the advanced trading platforms could execute a trade in one to 30 milliseconds. BATS started with a speed of one to three milliseconds.

Speed was nice, but BATS also had to compete on cost. And from the outset BATS was able to offer highly favorable economic terms to traders who used the system because it operates in a lower-cost environment than its big-city competitors. Its office space costs less than half what similar space in New York would run. Programming talent is about 35 percent less.

Even so, location put BATS at a slight disadvantage when it sought to sign up customers. It was a challenge to convince sharp-elbowed traders that it was safe to do business with the guys with flat accents out in flyover country. Securities traders go to dozens of conferences a year, where insiders gossip, but BATS found initially that few folks had heard of them. "We went to all of them but one," says Randy Williams, a former Dow Jones reporter who is now BATS's vice president for sales and communications. While attendees all knew the NYSE and NASDAQ, they had no clue what BATS was.

To lure new customers, BATS also experimented with a tried-and-true tactic: discounting. In January 2007, BATS slashed fees and boosted the rebates for users. For a month, instead of making a penny on every trade it executed, it lost 10 cents on every trade. But many firms lured by the obvious bargain to try the system stuck around after the special ended. "We picked up 5 or 6 percentage points of market share for about \$5 million," says chief operating officer Chris Isaacson, who grew up on a pig farm in Nebraska and was an All-American decathlete at Nebraska Wesleyan. Volume rose from 100 million shares per day to 265 million during the special, and continued to climb.

BATS missed its target of racking up a billion-share day by the end of 2007—but only by a few weeks. It hit that milestone on Jan. 23, 2008. And the little exchange is now a big player. Its customers include pretty much every name-brand investment bank, and it has enlisted several financial institutions as owners. Given its success, BATS has the potential to be one of those stocks traded with abandon over its wires. "It's certainly worth hundreds of millions of dollars," says Ed Ditmire, an analyst at Fox-Pitt, Kelton in New York. But Ratterman isn't interested in taking the company public. "We're building a credible, innovative market center with a 20-year time horizon," he says.

Yet BATS maintains the feel of a start-up. Instead of an executive dining room, there's carry-out barbecue for lunch. And BATS is constantly reminded of the vast gulf in size and resources separating it from its competitors. This past spring, it opened a New York sales office at 14 Wall Street, a building that stands across from the corner entrance of the New York Stock Exchange (14 Wall also houses 300 NYSE employees). From these small, unassuming digs, one can look into the window of NYSE CEO Duncan Niederauer's chandeliered office suite. Nonetheless, BATS is raising its profile. This summer, it began providing free quotes to Yahoo Finance, part of a broader effort to boost its name recognition. And this fall, it plans to take its show to Europe by opening a trading platform in London.

As the bells chime 3:30 Central Time, the New York Stock Exchange closes, and the streets of lower Manhattan briefly fill with men and women wearing the distinctive jackets of floor traders. They're off to the bars or the gym or their homes. In the BATS strip mall outside Kansas City, the Midwestern programmers aren't going anywhere. They're hunched over their screens, figuring out how to shave a few more microseconds off the trading process. "Geeks have taken over Wall Street," Isaacson says. He may yet be right.