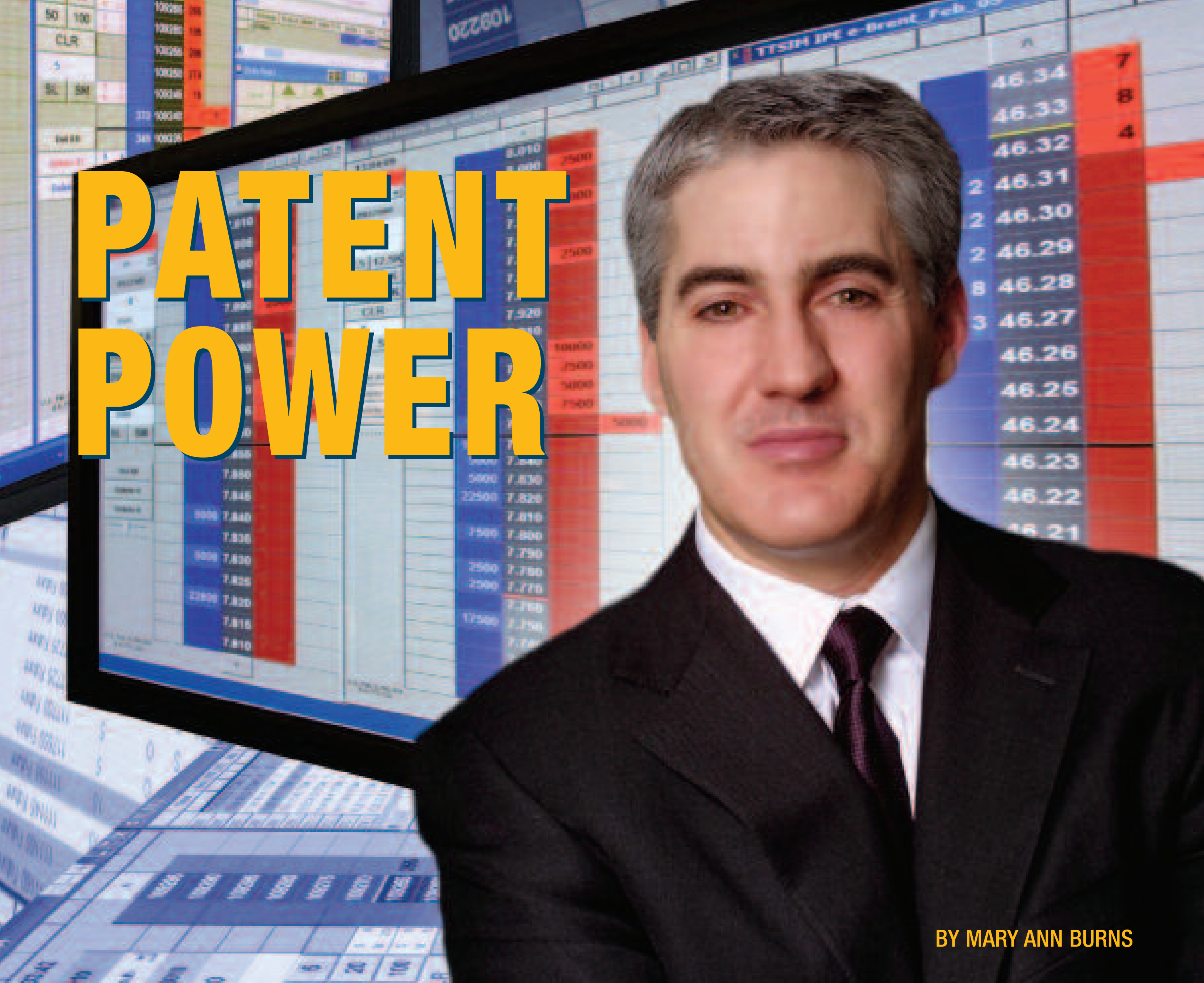

PATENT POWER

BY MARY ANN BURNS

FI INTERVIEWS HARRIS BRUMFIELD ON HIS PATENT PLAN

Trading Technologies' Dec. 15 open letter to the futures industry put forth Harris Brumfield's new business model for TT. The industry has been buzzing since the Aug. 12 announcement that TT had been awarded two patents from the U.S. Patent and Trademark Office for its MD (Market Depth) Trader concept and subsequently earned two patents from the U.K. Patent Office in November. With 80 more patents waiting in the wings, different players in the industry are trying to sort out what impact this news will have on their business. In his "manifesto," Brumfield proposes to give all TT's current and future intellectual property to the industry for free if the exchanges will pay TT 2.5 cents on every trade—permanently. Brumfield's proposal is conditional on permanent, level access to the participating exchange. If the exchanges don't buy into this, Brumfield says, TT will continue to go after patent infringements at brokerage firms, other ISVs and trading shops, charging a rate significantly higher than the 2.5 cent deal he is proposing to the exchanges. Brumfield agreed to address with *FI* some of the questions raised by his manifesto. (The open letter is posted at: www.tradingtechnologies.com.)

Burns: After you came off the floor in 1997 to trade on Eurex, what motivated you to invest in technology?

Brumfield: Going electronic, I thought that there had to be value in helping to offer a level playing field to pretty much anybody in the world. That's a big deal because the pits are limited in size. Not being on a level playing field is very, very tough for the confidence of a trader not in the pit. It eats on you. Even if you're good at your direction, it bugs you that your access isn't as good as the other guy's. Another factor that drove me to try and level the playing field—I thought if somebody didn't do some very high-end technology and pour it out to the world, we'd end up hurting ourselves as an industry. We'd end up with internalization. You're only as good as the product out to the customers—from end-to-end—liquidity, tightness, front-end technology, with arbitrage being very fast between markets.

Burns: How much impact did you have on TT's trading system?

Brumfield: I started out purely as a TT customer. I started investing in TT in early 1999. I've given TT every technical innovation that I've ever had. It's very rare to have a trader contributing all of his ideas to a tech company because most of the time a trader is going to hoard his best secrets. All in all, I've had a decent impact on TT's trading system.

Burns: When did you first apply for the MD Trader patent?

Brumfield: I transferred ownership of the idea to TT in early 2000 and TT filed for the patent soon thereafter, but it wasn't integrated into the product until late August 2000. We have two main patents right now, and there are 80 to 90 more pending, and TT continues to innovate and file for more patents.

Burns: Why did you decide to share your secrets with TT?

Brumfield: I have to admit, I wouldn't have thought of giving my ideas away for just the opportunity to make money on a patent. Somehow it had to be good for the trading I was doing at the time, too. Even if TT didn't do screaming well and only did okay. I was thinking that the industry would go bonkers. You want to spread this technology to end users all over the world and make it grow—you want speculators, hedgers, everybody to have the opportunity to participate on this level playing field. The minute they experience it, they trade more and more. The increased volume is good for everyone. In terms of my own trading, if the industry grew, I could trade within the volume much easier.

Burns: What made you think front-end technology would be a good business?

Brumfield: I had a lot of friends ask me that. They knew I was down a lot of money on TT, and some didn't even think we were going to make it. But when your customers are extremely healthy, with some individual traders trading up to two million sides per week, and they like your software, there are big possibilities.

Burns: What's your rationale for giving away your intellectual property to end users, FCMs, vendors and other ISVs and charging the exchanges?

Brumfield: What I like about giving up our IP is that it makes people compete like crazy. Right now if you have very strong intellectual property and you're enforcing it everywhere, it does of course put pressure on people. I prefer to give our intellectual property away. I'd rather stay away from lawsuits altogether, but I'm not going to stop. I have a fiduciary duty to TT. I'm giving Bloomberg, I'm giving Reuters, I'm giving CME, I'm giving everybody in the world all of this intellectual property, and any of the innovation we do for life is connected to it forever. And that's a big, big deal. Another key to this is that TT is only willing to give away its IP through an exchange that offers level access forever. After all, doing a deal with an exchange that wouldn't offer TT level access forever would not promote the industry and would be suicide for TT's software business.

Burns: How did you arrive at the 2.5 cents per trade fee you want the exchanges to pay you?

Brumfield: We think 70% of the volume at the big four futures exchanges is using the MD Trader concept. Considering early licensees already agreed to pay 10 cents per side for 16-year licensing deals, and the 10 cents per side is a minimum and is a significant discount, then I can't go any lower than 2.5 cents permanently from the exchanges. I can get, in effect, 10 cents plus on 70% of the volume for 16 years so surely 2.5 cents permanently on all of it is good. Besides, in this calculation, I didn't even count our other valuable 80 pending patents and more to be filed in the future. I think the small cut I'm asking for from the exchanges dwarfs what we would give to the industry.

Burns: Why permanent?

Brumfield: Well, the level access and continuing use of TT's IP is permanent, so this makes sense when trying to make the deal be parallel with the terms. Also, from a business case point of view, permanent, like any other term, can be looked at in terms of dollars. If you noticed, in the letter I said 2.5 cent solution. It might be possible to do away with permanent as part of the deal, but invariably, the price per side would probably move up to 5 cents per side to make the overall deal equivalent to the 2.5 cent solution. For many reasons, doing away with permanent and moving up doesn't make sense, and also, I believe the exchanges will relatively prefer the 2.5 cent solution. By the way, the proposed deal is not merely a patent license under TT's two issued patents. The proposal is a business deal, which includes terms well beyond a patent license. For example, the deal requires level access both ways. This includes guaranteeing the participating exchange has level access to TT's distribution forever.

> "TT supports competition. When we connected to the Eurex US platform, the CBOT dropped its fees. That wouldn't have happened if TT traders had not had access to Eurex US products."

Burns: After you released your letter to the industry, some pretty angry people were saying that you are holding the industry hostage and overestimating your contribution to the industry.

Brumfield: The hostage comments don't make any sense and the same people who are saying that know it. Considering we're down $32 million, I think we've scratched the industry's back pretty good up until now. All I'm saying is please scratch us back and if not I'll understand—I'll totally respect your decision. Regarding the "overestimating your contribution" comments, I'm perplexed—after all, the trading volume that goes through X_Trader dwarfs the volume of even the largest exchange.

Burns: Why wouldn't you just sell TT to the highest bidder?

Brumfield: Right now TT is great for the industry. It's not that whoever would buy TT is evil, it's just that they would try to make the most money from it in whatever way is best for them. It might not be as pure for the industry as it is today. I would hope people understand that, but it seems some people are missing the point. I've had people tell me that this crusade is crazy. "Just take an offer and sell it, Harris," they say. TT has no plans to create an auction to sell the company. Who knows, a sale could happen, but I expect not, as I expect the exchanges will elect to do business with TT. A contract with all of the exchanges would guarantee a level playing field where a marketplace could never choose sides and favor somebody as far as connectivity and access, speed, prioritization in product and on and on. That seems like a good decision to me.

Burns: But you're adding cost to every trade…
Brumfield: You're taking for granted our position right now. If we're not here, that fee is going to be much more than 2.5 cents. When you add an independent like we are, our value that we're contributing in dollars per trade is much more than 2.5 cents now. Take TT away, and you're net/net losing. Besides, the value of the MD Trader concept alone far, far exceeds 2.5 cents per side. Also, going forward, the newfound value of the TT volume-catalyst effect would dwarf a 2.5 cent inclusion.

Burns: What do you mean by volume catalyst?
Brumfield: TT's profits would be driven by volume, since the 2.5 cents would be fixed and volume-based. Therefore, TT's mindset would purely be of a volume-driving nature. I believe that an entity that is intertwined in an industry as much as TT is, and that has the perfect motivation, could be quite a catalyst for volume growth.

Burns: What happens if only one of the four exchanges accepts your proposal?
Brumfield: I believe that all four exchanges will elect to do the deal. I could be wrong, but that's what I believe.

Burns: TT's model has been to connect to the big four exchanges. Will you then connect with any exchange that will pay the 2.5 cents? Including non-futures exchanges?
Brumfield: We originally decided to focus on the big four exchanges because we wanted to focus on functionality and didn't want to spread ourselves too thin on 40-plus gateways. Our FIX gateway is allowing exchanges other than the big four to interface with TT. This access to a considerable pool of activity will be open to cash platforms, too—foreign exchange, fixed income, energy and so on. Interfacing to TT does not require the 2.5 cent deal. Just as TT is not requiring the big four exchanges to pay 2.5 cents per side, interfacing to TT's FIX gateway does not require other exchanges to pay 2.5 cents per side. However, I do believe that over time all exchanges will be attracted to locking in level access with TT and locking in all of TT's IP for 2.5 cents per side.

Burns: You say you are pro-competition, but aren't you having a chilling effect on competition by adding to the cost of trading?
Brumfield: It has already been proven that TT supports competition. When we connected to the Eurex US platform, the CBOT dropped its fees. That wouldn't have happened if TT traders had not had access to Eurex US products. BrokerTec Futures did not hook up to TT and CBOT didn't drop its prices. The Eurodollar battle between CME and Euronext.liffe wouldn't be as intense if TT wasn't in the mix. When you have exchanges on multi-exchange platforms, that is very powerful. I don't see how closed models have a chance. Traders are spread trading with multiple exchanges. They are feeding off each other. A big order in the bund dominoes into the 10-year notes and/or the Eurodollar and/or the Euribor. That domino liquidity is impossible to beat. The closed exchanges can't beat it. If the open exchanges start listing products from the closed exchanges, the open exchanges are going to beat them over time. The open movement is powerful. It's going strong and, in my view, is unstoppable. TT is a big part of that open movement, and going forward, the TT volume-catalyst effect would be great for competition and the value would dwarf a 2.5 cent inclusion.

Burns: What about the other ISVs? Aren't you driving them out of business?
Brumfield: The bottom line is that over time the market is going to kill any futures-focused ISV that lacks strong IP. eSpeed, as an exchange, subsidizing front-end software and having cash as a differentiator on its platform, is very much a threat to any ISV. Without strong intellectual property to answer such a threat, an ISV's very existence is in question. In other words, the only prayer TT ever had was having strong intellectual property. Interestingly, if no ISV had strong IP, this would've eventually forced all the

Who is Harris Brumfield?

Harris Brumfield almost never made it to Chicago. From the family farm where he and his three brothers grew up, he went to Mississippi State University where he was a finance major. After he graduated in spring 1986, he headed for Lake Tahoe to become a blackjack dealer. He was two months late for the annual dealer training in March. With no job and little money, he headed for Chicago where a college friend was working for Drexel on the floor of Chicago Mercantile Exchange. He slept on his friend's couch and talked his way into a job on the grain floor at the Chicago Board of Trade. He frequently crossed the bridge into the financial room where the traders were younger and the markets faster.

It was in the Treasury pits that he met Chuck McElveen who hired him as a broker's assistant and later gave him his odd-lot portion of the business. Brumfield took the money he earned and taught himself to trade. Six months later he gave McElveen back his business and started trading for himself. He traded on the floor for approximately 10 years, most of the time in the 10-year Treasury note pit. His trading success allowed him to invest in other ventures including a medical device company in San Francisco where he learned about patents and Trading Technologies.

As a floor trader, Brumfield watched the fundamentals. He traded bonds while looking at how equities, crude oil, the dollar, and commodities might affect the bond market.

"I did not want to be influenced by who was doing what," says Brumfield. "I wanted to figure out where I thought eventually everyone was going to come from a logic point of view and be ahead of the crowd."

He was ahead of the crowd when he left the trading floor in 1997 to trade on Eurex. He immediately liked the first-in, first out algorithm, the anonymity and speed he found on the screen. "I loved the floor—the camaraderie, pushing, shoving, competing every day," he says. "But I went cold turkey in 1997 and never looked back."—*Mary Ann Burns* exchanges to offer multi-exchange front-end functionality, as there's no way they want most of their volume going through eSpeed's order entry system.

Burns: What are the other ISVs going to do? Are they going to go for the same deal?

Brumfield: All ISVs can compete on their own merit. If the exchanges do the deal, ISVs won't have to worry about our IP and will be incented to innovate and compete. Also, some ISVs may obtain IP that puts them in a position to survive. The point is, TT's situation does not affect the fate of all other ISVs. In fact, a deal with TT makes it more possible for them to survive than the present situation.

Burns: Patsystems just filed a patent, are they going to say, "we love Harris' idea; we're going to have the exchanges each pay us 2.5 cents too to be able to use our innovation?" What about Rolfe & Nolan and SunGard? Don't they deserve 2.5 cents, too?

Brumfield: If whoever's innovation ends up being good enough, more power to them. The market will eventually determine the value of TT's innovations, and for that matter, whoever else's innovations.

Burns: Many people are skeptical that your patents will hold up. How confident are you that no prior art exists?

Brumfield: From my vantage point, those people's skepticism doesn't add up—it seems they're mostly just barking to bark. The MD Trader concept was completely contra trend to what had been going on for the 10 years prior to 2000. At the time, everyone was using the middle of the screen almost like a shooting target, and they were making the prices rotate. I chased the bid and the offer and kept the prices static. We've personally searched the world for five years trying to invalidate this concept and found nothing relevant. Most importantly, three independent organizations, the U.S., U.K. and E.U. patent offices, all validated the MD Trader concept. Some have suggested that the U.S. Patent and Trademark Office grants patents too easily. That was not the case with our patents. The two issued patents were rigorously examined by the patent office. Both went through a special quality review procedure. Under this procedure, not only was the patent application reviewed and approved by a senior examiner, but it was examined a second time by a special group in the patent office to make sure that the decision to grant the patent was solid. In doing its review of TT's patents, the U.S. patent office looked at over 50 different prior art references. And the particular group that examined TT's patents is one of the toughest groups in the patent office in terms of allowance. This group has an allowance rate of 16% compared to an average allowance rate in the overall patent office of around 70%. Further, we have 32 declarations from some of the who's who in trading from around the world and across all asset classes. They all independently verified the original and revolutionary nature of the invention under penalty of perjury. We could have gotten five times more, but we ran out of time. In light of all this, I'm very confident that the different court systems will protect our patented innovation.

Burns: What has the response been from the exchanges?

Brumfield: Well, the responses are all over the place—some negative and some positive. One aspect that creates negative feedback is that it's counter-intuitive for an exchange to support a multi-exchange platform where competitors can piggyback on their contracts. On the other hand, a common thought is that if the industry had an independent catalyst in the middle, the industry would see further volume benefits. Dialogue continues to be active with multiple exchanges. Again, I have confidence that the exchanges and TT will do business. ■

Mary Ann Burns is editor-in-chief of *Futures Industry*