WHAT THE NYSE-ARCHIPELAGO MERGER MAY MEAN TO CORPORATE FINANCE MANAGERS

The surprise announcement in April 2005 that the venerable New York Stock Exchange (NYSE) would be combining resources with the upstart electronic exchange, Archipelago, signaled how dramatically the financial markets have been changing. In the discussion about the future of the NYSE that ensued, the importance of the stock exchange mechanism to the well-being of the capitalist system was the focus of much media coverage. We who benefit from the smooth operation of the stock exchanges take the concept for granted, it would appear, but with the NYSE itself considering a partial or perhaps even total dismantling of the specialist-centered auction market system, it seems that nothing can be taken for granted now in the canyons of lower Manhattan.

The NYSE began business more than two centuries ago — few American financial institutions are as old—and for many in the U.S., the NYSE has long been the primary symbol of the capitalist roots of the United States. If the NYSE itself physically disappears after all these years . . . *what then?* Welcome to the increasingly globalized and ever-more technology-driven financial marketplace of the 21st century!

While one can count on Wall Street to make dramatic moves and to lead innovation in the financial markets, the proposed NYSE-Archipelago combination is an absolute stunner. Before we explore the implications for finance executives, we'll discuss some background on the major player in this drama, the NYSE.

NYSE is launched under the buttonwood tree

As the government of the newly formed United States of America was organized in the new nation's original capital, New York City, 24 merchants gathered nearby under a tall buttonwood tree on Wall Street close to Federal Hall, the seat of the new government presided over by President George Washington. The merchant-brokers assembled in May 1792 to arrange the trades in the public debt (bonds) issued by the new nation, a relatively small state by today's standards, that was formed by the 13 colonies' joining forces to fight a war of independence with Great Britain. When victory was won and a new nation created, the debts of that conflict were considerable ($80 million); the new country had great hopes but little capital and owed hundreds of millions in 2005 dollars.

The group under the buttonwood tree took the first steps in forming a means of trading securities — an organized method of exchange—with merchant bankers and brokers representing buyers and sellers. From the shade of the tall buttonwood, a survivor of old Dutch New York, today's powerful New York Stock Exchange would evolve. Trading moved indoors to the Tontine Coffee House, and later, to the Exchange's first office in 1817 (the first of several homes before settling on the corner of Wall and Broad Streets).

Wall Street is the name given to the little lane where the Dutch built a wooden wall to keep the invading British outside the trading village. While the wall was eventually

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removed and the city expanded beyond its former boundaries, the traditions of the street's insularity in many ways were maintained by the clubby crowd that would manage and guide the NYSE over succeeding decades. The NYSE is chockablock with traditions, which is all the more reason why the proposed merger is so astonishing to observers. The NYSE was long a membership-owned entity, organized similarly to a country club. In fact, 20th century journalists and pundits nicknamed the place "The Club," for its well-known "insider" atmosphere and mostly closed ways of doing business.

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The central auction system

One tradition relevant to this discussion is the central auction market concept, the "open outcry" method of matching bids and offers, a human-based system surviving into the 21st century even as other major global exchanges (such as London) move to high-speed electronic systems and "humanless" trading. Arguments have raged for three decades over whether electronic or human systems provide the investor with the best deal on prices for issues. (The concept is that the self-interest of the bidder will not allow another bidder to "steal" a stock at a lower price in a truly open and honest marketplace. This led to the "perfect market theory" and the belief that the NYSE's open outcry auction process yielded the best prices for both buyer and seller.) The merger, if completed, may finally settle the debate in favor of e-trades; human intervention in stock trades may fade into history like the old Dutch wooden wall and the buttonwood tree, which died of old age in 1865.

Over the decades, the NYSE has become a very efficient auction market, with the floor traders holding forth at their trading posts and floor brokers representing buyers and sellers coming to one designated spot to trade. Over time, some traders became known as "specialists" because they specialized in the issues of only a limited number of corporations and made a market (that is, ensured order and liquidity) in those stocks.

Today there are 1,366 "seats" or members owning the organization we know as the NYSE (owners are individuals, partnerships, and corporations). The NYSE has technically been a New York State not-for-profit corporate entity since the early 1970s. This puts many aspects of NYSE governance under the jurisdiction of the crusading state Attorney General Eliot Spitzer and state, not federal, statutes and regulations.

"Membership" has changed considerably in recent years. At one time, an individual literally bought a seat on the exchange (conferring exclusive trading and governance privileges); today, seven large companies own roughly 700 of the seats, and many others are "owned" nominally by the specialist but are in fact financed and considered to be owned by their employers, including Morgan Stanley and Merrill Lynch. Seat prices have ranged from several hundred thousand dollars in the 1970s to the first $2 million purchase (in 1997). Seat prices escalated after the recent merger announcement.

NYSE and the competition

Over the years other stock exchanges emerged, in New York City and around the nation. The other major New York securities trading institution was the American Stock Exchange (AMEX), starting life near the NYSE on Broad Street and known as the "Curb Exchange," as traders and runners crowded in the street and perched in open windows in the building to shout bids and offers to each other! The AMEX moved to its own building and trading floor and, in time, another trading mechanism emerged—a primitive quote system operated by the National Association of Securities Dealers, known today simply as NASD. The old-fashioned printed flyer long served as listing sheet for buyers and sellers and individual NASD members made markets in specific issues (differing from the NYSE in that numerous member firms could make a market in a stock).

In the early 1970s, the NASD invested significant sums in state-of-the-art technology to create the NASDAQ Exchange, the "AQ" standing for "automated quotation." Quaint by today's standards, the system was revolutionary three decades ago but looked down upon by traditional auction market advocates. There were also stock exchanges established over the years in key regions of the U.S., including exchanges in Philadelphia, Chicago, San Francisco, and Cincinnati. Some corporate issuers listed for trade on multiple exchanges with their key listing being either the NYSE or the AMEX.

For several decades, there was an established pecking order as well as transitions established for public company issues. A small cap firm or initial public offering (IPO) might list on the NASD "sheets," thence moving to the NASDAQ quote system after the 1970s; in time, the firm would move its listing to the AMEX and finally, in a signal that it had come of age, the firm would list on the NYSE ... the "Big Board," members declared, as if the others were for the smaller and less significant firms.

The familiar auction market concept—one specialist making a market in a stock, buyers and sellers (represented by "commission brokers") coming to the trader's post to cry out their offers and counteroffers—evolved in the 1870s and has been heartily defended over the years by the NYSE, even as alternatives emerged, many due to advances in communications technology. More important in recent decades is the power of institutional investors to drive trading costs down; one of the major life-changing events for the NYSE occurred when fixed broker commissions disappeared in May 1975 in the "Big Bang," setting the stage for many recent developments, including the proposed combination with Archipelago. (The fixed rate for trades was roughly 1 percent of the dollar value of the transaction; the system had been in place for 183 years! Escalating volume created by the entrance of institutional investors to the stock market created pressure to drastically reduce prices, beginning with "block trades" in the early 1970s.)

The Securities Acts Amendments of 1975 (passed by Congress) created a national market—the Intermarket Trading System—that through an e-network connects the American, Boston, Chicago, Cincinnati, New York, Pacific and Philadelphia stock exchanges, as well as the Chicago Board Options Exchange and NASDAQ. Many NYSE-listed stocks are thereby executed on other exchanges (wherever the best price can be obtained). Moves such as these set the stage for greater competition among exchanges, reduced NYSE dominance of exchange markets, and a blurred line between the competing systems.

A tradition of raising capital for entrepreneurs

The early primary corporate beneficiaries of NYSE trading were banks and insurance companies coming to raise capital. Later, as technological breakthroughs occurred and the U.S. grew to become a major industrial global power in the 19th century, joint stock companies raised capital to build canals and private roads, railroads, and telegraph and telephone systems. NYSE beneficiaries included investors in Mr. Thomas Edison's comprehensive urban electric generation systems, Mr. Henry Ford's assembly line-built horseless wagons, the Wright brothers' aeroplane, and so on, all the way (over 150-plus years) to the wondrous Era of the Internet of the late 1990s. There were many bubbles and market collapses over the years, but investors always came back to the NYSE!

Today, trillions of dollars of debt and equity issues are traded each year on the NYSE; more than 3,000 companies have chosen the NYSE to list their issues for trade, including firms headquartered in Canada, Europe, Asia-Pacific, Latin America, and Mexico. The NYSE still maintains the major portion of the share volume of NYSE-listed stock transactions.

Symbol of American financial strength

The NYSE represents an important symbol of American capitalism to the nation and the rest of the world. Recall the NYSE opening bell, rung by firefighters and police, sounding the resumption of trading on that September Monday morning after a heroic effort to marshal the resources to get on with business following the terror attacks on the nearby World Trade Center. Wall Street workers and executives were shaken by the events of September 11, 2001, and the financial district infrastructure badly damaged, but the opening of the NYSE for business gave confidence to the nation.

As volume increased in the late 20th century, the NYSE invested heavily in tech-

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THE PRICE OF A NYSE SEAT FELL BELOW $1 MILLION IN 2005.

nology—billions of dollars' worth over three decades — to handle more shares traded, ensuring faster and more accurate trades, and to move processing from paper and specialist "book" to electronic digits to match buy and sell orders in hand-held computers and "Display Book" workstations. In 1970 "electronic books" were introduced; by 1999, a "virtual reality" system was installed, a dazzling 3-D trading floor matching the complexity of global trading. (The first billion share day was reached on October 28, 1997; since then, several billion shares can be traded with ease on a given day.) The NYSE has invested more than $1 billion in technology over the past two decades.

The news media began to base correspondents and commentators at the NYSE in the 1990s; the public became familiar with the trading floor and other features through global broadcasts of CNBC, Bloomberg Television, MSNBC, CNN, and other networks. The NYSE logo became better known around the world.

Today: astonishing changes proposed

And so we come to spring 2005's dramatic events: the American and global technology revolution of 1975 to 2005 created opportunities for attracting corporate listings and wooing investor dollars—but also created difficult moments for NYSE. The barriers to entry for new exchange formats fell and the traditional corporate march to greatness—*OTC to NASDAQ to American to New York listing and trading*—faded as Microsoft (MSFT) and other large-cap companies chose not to list on the NYSE. Upstart "electronic communication networks" (ECNs) emerged over the last decade. The price of a NYSE seat fell below $ 1 million in 2005.

A rash of scandals brought about major changes in governance. NYSE Chairman Richard Grasso left as the New York attorney general began efforts to reclaim compensation that Grasso had received (with board approval). (Attorney General Spitzer cited New York's not-for-profit laws as basis for his actions. A new chairman was brought in, the board was re-organized, and a new management team installed.)

Then in April 2005 came the second"Big Bang" announcement: the NYSE would merge with a relatively new public company to create a major new exchange, part physical (at 11 Wall Street) and part cyberspace, in the shell of a publicly-traded company. Many questions immediately arose about the future of the two-centuries-old NYSE that now intends to merge with Archipelago Holdings, a nine-year-old public company. The NYSE membership-based, not-for-profit entity would reverse merge into a publicly traded company so that seatholders would be able to liquify their holdings. The bid for a seat rose to $2.5 million and more.

What does this mean for corporate finance managers? Issues include:

- Investors feel a certain loyalty to NYSE, which has worked long and hard to become the brand name in U.S. stock trading. The magic of the NYSE marque also extends to global markets. As long as the name remains, "New York Stock Exchange" will mean the traditional seat of power of the U.S. financial industry. Or will it, if there is no physical "place" where trading occurs?
- What will the term "A NYSE Company" mean to investors in the future? If a corporate share can be traded in any of a dozen or more locations, what will a NYSE listing mean to the corporation?
- The regulatory function of the NYSE, as a federally chartered self-regulating organization (SRO) approved by Congress in the 1930s, must be determined. A new, independent regulatory entity could emerge, as with NASDAQ, further complicating life for listed corporate boards and senior management in the post-Sarbanes-Oxley environment. The rules for listed companies could become more stringent if a regulatory-only entity is created for NYSE-listed firms.
- Institutional investors will be most affected, notes Wharton University finance professor Jeremy Siegel, who thinks it is time for the NYSE's traditional public outcry system to fade away. Buy-side managers want cheaper, faster, and more efficient

trades; and, he says, the price spread will really only matter to big-volume traders.

- Most important is that falling prices—say, to one cent per share traded—will eliminate today's three-to-five cent per share cushion that pays for much financial analysis and research. This was a much-discussed topic at the recent Investorside Research Association meeting in New York City; who will pay for research is the huge, undecided question, and the NYSE-Archipelago proposal could be disastrous for the broker-sponsored stock research as we have known it. Already hundreds of public companies are without any research coverage at all; there could be a two-tier market, with relatively few corporations having regular coverage by one or more "name" analyst.
- Copycat moves could change the face of trading even more; on the heels of the NYSE announcement, major competitor NASDAQ—the world's largest electronic stock market with 3,271 companies listed—announced it would buy Archipelago competitor Instinet for almost $2 billion. The two moves consolidate power in what will remain of NYSE and NASDAQ. These two exchanges will have concentrated power, the effects of which are difficult to predict.
- Stocks and bonds were staple offerings of the NYSE for decades; in recent years, a wide variety of offerings became available to investors. The two major exchanges will be equipped (and financially capable) to offer a dazzling array of debt, equity, and hybrid products to domestic and global investors. The corporate finance manager's choice of how to go to market—debt, equity, public or private money, or various combinations—could change in dramatic ways in the coming months, especially as the surviving exchanges create competitive products (such as the NASDAQ 100, exchange-traded mutual funds, and the AMEX's Spiders).
- Will a "listing" have the same meaning for issuers, investors, regulators, and other market players in the future? What will *your* company's listing—say, it is on the NYSE today—mean to institutions in the months ahead?

At this writing, the dust has not yet settled on the exchange transactions, and regulatory hurdles or lawsuits could delay or derail the proposed deals. The NYSE announcement focused corporate and investor attention on the importance of the traditional stock exchange—the auction market in particular—and underscored the dramatic nature of changes still in store.

While "seat holders" may be most affected day-to-day, corporate finance managers have a huge stake in the outcome of the proposed transactions. Life will not be the same on Wall Street in the years ahead—the "Street" itself will see to that.

Perhaps the most hoped-for outcome for public corporations that list—whatever that term may mean in the coming years—on these exchanges is that investors will be attracted to the best possible deal and continue to march to markets bidding for their individual and institutional business, ensuring an efficient capital-raising mechanism for issuers. •