TRADING TALK

Market Structure Analysis & Trading Strategy

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ROSENBLATT SECURITIES INC.

Déjà vu: Consolidation Leaves Two Old Rivals in Head-to-Head Competition Once Again, but this Time with Modern Day Automation

While we'd like to say we weren't shocked by the Arca/NYSE deal, we can't. Looking back though, the signs were there, both in terms of the pairing and even the timing. Not only had John Thain been one of the architects of Goldman Sachs' investment in Arca when he was there and an advocate of increasing automation since he joined the NYSE, but just a little over a month ago at the Hewlett-Packard Exchange and Clearing Forum he foreshadowed the deal by expressing the need for consolidation in the US marketplace. He said, "I do think the U.S. market is substantially behind the European markets. I feel that there needs to be much more consolidation. We have too many exchanges… [and] our markets are fragmented product-wise." Combined with recent high-pressure lobbying by NYSE seat holders to find a "going public" solution to raise the value of their seats, and the "market" itself (as usual!) smartly anticipating the move with seat prices exploding from under $1 million in January to more than $1.6 million in the few short months preceding the deal, these facts arguably should have made the announcement less surprising than it was. Thain and the rest of those involved did a great job keeping the deal under wraps as it was contemplated and negotiated. In fact, floor members in general (even some members of the Board of Executives) were pretty upset that they were kept completely in the dark about the deal. Nevertheless, this obviously was the right thing to do from Thain's perspective, especially considering that its disclosure would have constituted material non-public information about a publicly-traded company, Arca. Interestingly, this is something current members (who will simply become users of the NYSE down the road) are going to have to get used to when the NYSE is run for public shareholders instead of its membership.

Now that the basic facts are out in the newspapers, we thought we'd do a little analysis of the NYSE/Arca merger and attempt to identify implications. Of course, whether this is a "good" deal or "bad" deal (the most common question we get asked) depends on where you're sitting and also can change over time in very unforeseen ways. For instance, when Goldman Sachs paid $6.5 billion for Spear Leeds back in 2000, seemingly they were buying a top OTC market maker. A couple of years later when the bubble had burst and the rise of ECNs had radically altered the OTC business and decimated market makers, it seemed like the specialist unit might be the hidden gem. Not long after that, in the wake of the Grasso debacle and specialist scandals, this analysis too proved misguided. Today, with all of the focus on controlling the desktop and electronic direct market access (DMA), it would seem that Spear Leed's RediPlus front-end and its early penetration of this market space might prove the true crown jewel. We'll see. With respect to comments on the merger, at minimum we'll try to offer some insights that reporters can't be expected to make without the proximity to the floor and the knowledge of markets a broker possesses.

Richard Rosenblatt
rrosenblatt@rblt.com

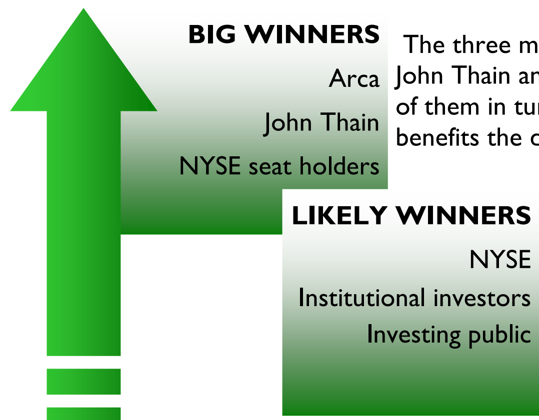
Joe Gawronski
jgawronski@rblt.com

20 Broad Street
New York, NY
(212) 943-5225

Winners and Losers

Because so many unanticipated things can happen over time (as with Goldman's Spear Leeds acquisition), we always hate to answer this question, but everyone always wants to know who are the winners and losers in a transaction (and what was each party's motivation for entering the transaction and what do they get out of it). We'll give it a shot with that caveat and an apology. We had hoped the passing of Reg NMS and the advanced status of the hybrid would

soon allow us to begin moving back into the realm of giving real-world trading advice, but it looks like events are keeping us in the world of speculation a while longer.



The three most obvious winners in our view are Arca and its shareholders, John Thain and NYSE seat holders (probably in that order). Let's look at each of them in turn. With respect to Arca, aside from the obvious monetary benefits the deal brings shareholders (as reflected in the explosion in its stock price upon the deal announcement), there are a number of other advantages that come from teaming up with the NYSE. First, this deal gives Arca the size and brand name to compete globally in a rapidly consolidating space. Second, this muscle gives it added strength to compete against a combined Nasdaq/ INET entity for Nasdaq flow. Once Arca passed on acquiring Instinet and let Nasdaq walk away with it, it potentially would have been in real trouble since stand-alone it would have just shy of a 25% market share in Nasdaq stocks versus a competitor that would have most of the remainder and liquidity tends to begets liquidity. Third, despite Arca's great success in the Nasdaq market and in ETFs, it had largely failed to penetrate the listed market, which had always been considered the big growth opportunity in stocks with the Nasdaq market so carved up already and hyper-competitive on the pricing front.

John Thain also looks to come out a real winner in this transaction. It's a coup because by buying rather than building he accelerated obtaining the growth vehicle that he properly assessed was a prerequisite to being a successful public company. The deal satisfies the increasingly vocal demands of the seat holders to do something about seat prices. It also increases the size of the company at which he is at the helm and allows him to serve shareholders (something he is probably more comfortable with than dealing with a diverse constituency called "members" that often have conflicting interests). Of course, there is still deal risk, most notably SEC and antitrust approvals and the membership vote. However, Chairman Donaldson's early positive comments suggest that the SEC and antitrust officials (guided by the SEC) are likely to bless the deal and Thain is likely to get the votes he needs (2/3 of the seat holders), even if the terms have to be tweaked a bit to mollify some disgruntled seat holders who are demanding more cash and/or a shorter lock-up period. As further evidence that these "winner and loser" characterizations can get turned on their head very quickly, Thain could easily be tarnished with accusations about Goldman's conflict-of-interest (considering his history with the firm) or undervaluing the company as third parties attempt to break-up the transaction (e.g., yesterday's announcement that Kenny Langone is considering assembling a consortium to bid for the NYSE).

LIKELY LOSERS

Specialists

Floor brokers

Sell-side generally

BIG LOSERS

Amex

Nasdaq

With their demands met for "going public," albeit in a manner different than they likely contemplated, seat holders appear to be big winners too, even if the NYSE is overpaying. At the current level of the Arca stock price, the value of the stock and cash NYSE seat holders should receive under the terms of the deal approaches the all-time high for seat prices in 1999, \$2.65 million. Importantly, this is up sharply from January levels that had actually breached the \$1 million per seat mark and even from \$1.62 million, the last sale prior to the day of the transaction. While seat holders will certainly fight for an even greater piece of the pie over the ensuing months, it's hard to imagine that a good part of that is not just "trading" and that overall they would not be pleased with such a price (assuming Arca's stock holds up). And if the undervaluation is so severe that it has effectively put the NYSE "in play," seat holders will benefit even more.

Once you get beyond these three clear-cut winners, we start to feel the picture gets a bit murkier and the jury will be out for some time. The NYSE as an institution probably ends up a winner in this transaction. First, there are the articulated rationales for the deal, which are real, but have been well-covered already. It gives the NYSE four important things: 1) a speedy avenue to go public, global heft and the currency for further consolidation, including a trans-Atlantic deal at some point, 2) an instant multi-product platform, including ETFs, bonds and options (perhaps even a vehicle to offer the holy grail of combined options/stock trading), 3) an entry into Nasdaq stock trading and a second listings business for stocks that don't qualify for the NYSE's tougher listing standards, allowing the NYSE to finally solve its conundrum of how to trade Nasdaq stocks and compete for listings without devaluing its brand and risking its lucrative current high listings fees, and 4) an entrepreneurial partner that has a proven track record in technology innovation that it can leverage as it pursues the hybrid.

Then, there are a couple of other less discussed benefits. The Arca deal offers an intangible perception boost for an organization that has been mired in the Grasso pay scandal and specialist improper trading allegations, as well as being generally perceived to be bureaucratic, stodgy and clinging to the buggy whip in an age of automobiles. Frankly, the deal not only allows the NYSE to co-opt and silence one of its most vocal rivals, but also may mollify other vocal critics like American Century. It also gives the NYSE a lot more flexibility as it moves forward. The regionals and the Amex were always believed to be great places for experimentation for our capital markets, almost like farm teams to major league baseball, and ETFs in fact proved to be one of the superstars that came out of this system. The Arca deal and maintenance of two separate platforms will allow the NYSE to experiment on Arca without as much risk of devaluing the brand or too quickly altering our capital markets.

There are naturally some negatives as well from an NYSE perspective. Overpaying is probably the biggest issue in the short-term. The reaction in Arca's stock, a growing chorus of seatholder malcontents and our own back-of-the-envelope calculations of potential NYSE valuation relative to other domestic and international publicly traded exchanges, supports this view. Even Benn Steill, despite being a long-time NYSE critic, was attributed in the WSJ as saying the NYSE should have ended up owning 90% of the combined entity. Over the longer-term, we wonder whether the pressures of being a public company could push the NYSE into a move towards full automation. Even though Thain and Gerry Putnam went through great pains to stress that the platforms will not be combined, the floor will continue to exist separately and the hybrid transformation will continue, over time there will be pressures to integrate. While this might be appealing on its face to many constituencies, we actually believe this would be a mistake for the markets and likely result in the NYSE ironically losing its dominant market share. But we'll explore that a bit later.

Institutional investors and the investing public also look like winners. With $100 million in cost savings planned in 2005/2006 in the combined entity and another $100 million in 2007 and perhaps a greater percentage of fully automated trading down the road, fees investors pay for accessing the Exchange could well slip, benefiting the investing public. However, there is another side to this coin. As Fidelity has already suggested, fewer competitors could at some point finally halt (and even reverse!) the long slide in commissions on both the listed and OTC markets. In particular, the race to the bottom on ECN commissions could end as competition rationalizes under a duopoly (although even this could end up having the opposite effect in the near-term if the NYSE Group aggressively attempts to win Nasdaq share, funding losses through profits from the listed side of the business). Hopefully, the maxim "be careful what you wish for" will not ultimately apply in this instance.

One of the most obvious losers in this transaction is the American Stock Exchange. In fact, it may be mortally wounded by the deal. Already having lost most of its market share in the product it invented, ETFs, the Amex will be hard-pressed to recover as the NYSE more aggressively pursues ETF listings backed by Arca's 25% market share in ETFs. With a second listings market available through Arca and the NYSE's intent to re-enter the options business through Arca's ownership of the Pacific Stock Exchange, the Amex's stock and option business will also suffer.

Nasdaq is arguably a loser in the NYSE/Arca tie-up as well. Not only was Nasdaq upstaged on the PR front with respect to its own long-speculated deal with Instinet, but it finds itself again playing second fiddle from a competitive standpoint when it thought it was going to be the new 800 pound gorilla (sewing up most of its own market share with successive Brut, Island and Instinet deals). Nasdaq for the first time finds itself as the hunted with respect to trading its own listings rather than the hunter with respect to trading NYSE listings. Despite having desired to trade Nasdaq stocks for many years, the Exchange was always unwilling to risk any negative impact to its core listings business (with its much higher listing fees than Nasdaq), and this deal has now given them a clever way to compete head-to-head and go after Nasdaq listings and volume by keeping things on two platforms.

And make no mistake that Nasdaq will be the much smaller of the two firms. While Nasdaq will have the largest OTC market share following its acquisition of Instinet, it will have a formidable competitor in the new NYSE Group, which starts off with nearly a 25% market share in Nasdaq listings in addition to its more than 80% share in listed stocks versus a share of only a few percentage points in listed business for Nasdaq (excluding trades simply printed by broker-dealers in the third market). That said, it is too early to tell. Nasdaq will also have a greater opportunity than ever on the listed front, being able to consolidate the volume (albeit small) of all four systems and having Arca taken out of the listed battle (we can't imagine that at least in the near-term that the NYSE will allow Arca to aggressively pursue listed business, e.g., the ad campaigns will surely end, or even innovate all that much in the listed arena, with the NYSE wanting to give the hybrid a shot).

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With respect to losers in this deal, it's probably a long-term negative for specialists, floor brokers and the sell-side in general. This transaction is representative of the trend for exchanges to de-mutualize and become for-profit entities, e.g., ISE, Arca, CME, Nasdaq. One can argue whether this is good for the markets as a whole (while the greater efficiency implied by consolidation and greater automation should be a huge benefit to cost reduction, for-profit entities are not renowned for passing along savings especially in the context of decreasing inter-market competition that might make oligopoly pricing possible), but it definitely represents a transfer of wealth from the sell-side to public shareholders.

Costs will undoubtedly be pushed onto former members to profit shareholders of the new entity and revenue opportunities in the form of market data revenues or transactions fees will likely be shared as little as possible with the sell-side. For instance, when the NYSE becomes subject to the discipline of the markets for its P&L and it doesn't have to answer as directly to member firms, it is hard to imagine that technology provided by the NYSE for free to members today (*e.g.,* BBSS) won't be charged for in the future. Similarly, when the NYSE decides how it will price the licenses that will be needed to conduct business when ownership of the Exchange is separated from trading rights, a decision that benefits the NYSE and its shareholders by charging more to sell-side firms than today's lease rates would not be surprising (although in the near-term, we expect the NYSE will not want to rock the boat on that front, and while it will have control over pricing it will surely be subject to SEC approval, as will raising or lowering the current number of trading rights from the 1366 that is enshrined in the Securities Exchange Act).

Also, recall that for many members, the blow from any negatives in the deal is not actually softened by the monetization of their seats. The majority of members do not actually own their seats, but instead lease them, often from retirees who were previously involved with the Exchange. Independent floor brokers tend to lease their seats, whereas specialist firms are larger and usually own at least some seats, so specialists may fare a bit better in terms of the asset boost from seat sales. Specialists might also see a silver lining in the potential that maybe they will eventually be permitted to make markets in Nasdaq stocks from the post—but only time will tell if that will happen. It is important to note generally that the interests of the lessees and seat owners might be very different in this deal.

Does this Represent the Triumph of One Model vs. All Others? Is this the Beginning of the End of the NYSE Floor?

Over the coming weeks, we will undoubtedly see various spins on the deal that attempt to paint it in black and white terms. For example, that Arca, the most vocal critic among NYSE's competitors--with ads to this day equating the NYSE with "dinosaurs" and actually producing a song entitled "Joey the Specialist" poking fun at specialists (as an aside, it happens to be hilarious if anyone wants us to send them a copy)—has sold out to its arch-enemy. Or likely more prevalent, that the deal represents a capitulation by the NYSE and the recognition that fully-automated markets are the way of the future. In fact, we are already starting to see these stories. Long-time NYSE critic Harold Bradley of American Century was already quoted as saying, "I feel like Luke Skywalker after he killed Darth Vader," and the WSJ has run an editorial entitled "Big Board is hoisting the white flag" and an article called "Putnam's Revenge." While this makes for exciting journalism, as usual the truth is closer to grey than black and white. Let's examine the case for a grey hue interpretation of this deal.

One of the most interesting things in the evolution of our market structure over the last several years is how automated ECNs and manual exchanges have been converging in terms of functionality…If anything, rather than being a clear victory for the fully automated or the manual camps, this merger represents a continuation of a trend that recognizes that each model has something to add…

One of the most interesting things in the evolution of our market structure over the last several years is how automated ECNs and manual exchanges have been converging in terms of functionality. ECNs have adopted reserves, pegging and other features that attempt to approximate functions brokers/traders perform and Nasdaq and Arca have started opening and closing crosses to enhance price discovery and be more auction-like. The NYSE, on the other hand, launched an auto-ex product, Direct +, in 1999/2000 that already is responsible for more than 10% of the NYSE's average daily volume, and made a decision last year to adopt a hybrid with reserves, sweeps, algorithms, and other ECN-like features. This merger takes the convergence to another level. If anything, rather than being a clear victory for the fully automated or the manual camps, this merger represents a continuation of a trend that recognizes that each model has something to add and that convergence to markets that are more automated but keep some of the valuable features of human auctions may be the right path.

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We would not conclude that the transaction heralds the beginning of the end of the floor, as many are intimating. To begin with, it is important to note, who acquired who. Thain has made clear that this is no merger of equals, but a takeover. A premium was paid for Arca (that still leaves it with only 30% of the combined entity, and arguably less, since NYSE seat holders will also receive $400 million in cash as part of the deal), Arca will have only 3 of the 11 Board seats and Thain will be CEO, not Gerry Putnam, who will merely be one of three co-Presidents (and incidentally was relegated to remaining on the conference call with analysts at the time of the deal announcement while Thain went on TV!).

While we could have a lot of fun with Goldman Sachs conspiracy theories like the press has started to do (noting their Arca stake, dual advisory role in the transaction, Spear Leeds specialist operation and seat ownership, Thain's former employment and long expressed desire to move to more automated markets that would presumably make internalization a lot easier to justify) or even more benign domino effect theories (*e.g.,* that giving customers a real choice for the first time will spell the inevitable end of an "archaic" floor system or public company quarterly earnings pressure leading at some point to a focus on slashing expenses that will result in the abandonment of the much more human intensive, costly model of the floor), if we were to wager money, we'd likely take the over in any over/under poll concerning the length of time the floor survives. There are three primary reasons for this view.

First, we do take John Thain and the rest of the officials at their word that there is no intent to eliminate the floor and that the platforms will remain separate (at least for now). We not only believe their words and that there are genuine advantages to this approach, but also think that these public statements and the proxy statement that will follow will actually make it legally advisable not to depart from the stated plans for at least a couple of years.

Second, Arca and other ECN competitors have failed miserably at taking meaningful share in listed trading from the NYSE thus far. Regulation can at best only explain part of this failure. If the NYSE were to decide to switch platforms to cut costs and please shareholders, it could end up missing the forest for the trees. Such a business model change, from a system able to maintain 80% + market share to an all-electronic platform that has only been able to garner a couple of percentage points would entail a high risk of market share loss. It would potentially commoditize the market and allow a combined Nasdaq/Instinet to compete more easily in a battle of two similar fully automated systems. Utilizing Arca's automation expertise to assist with the hybrid transition is a much safer, logical evolution than would be a radical switch, even if ultimately the market were to go fully automated. Remember, despite being seemingly universally disliked, the NYSE is the choice investors make today for over 80% of listed trading. Empirically, transaction cost analysis (TCA) providers Plexus, Elkins/McSherry and Abel/Noser consistently rate the NYSE as having lower trading costs than the Nasdaq. Anecdotally, most of our quant clients who measure the difference between NYSE and Nasdaq execution quality also suggest that they find their executions on the NYSE either equal or superior to Nasdaq. While the human auction certainly can't win a contest on expenses, if the model offers real value to the investing public, particularly with respect to dampening volatility and in illiquid and semi-liquid names, shutting it down 5-10 years from now would be a bad thing for the markets.

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Also, the popular solution to go "all-electronic" for the top couple hundred names and trade the remaining couple of thousand stocks via the specialist system (a solution even Thain has hinted he favors at times) would entail its own risks. Since specialists claim to make the vast majority of their profits in those high-volume names, they might not be able to survive with just the illiquid ones. More importantly, by rule specialists are only permitted to trade the firm account when they improve price or volume. This suggests that as long as the rules are being observed (which we expect they are now and will be going forward in light of the serious punishment meted out for much lesser violations as a result of the specialist investigations) there would always be a cost savings to the other side of the trade when the specialist uses his/her capital. Since most specialist trading is in the most liquid names, the savings to the public must be significant, in addition to any volatility dampening benefits. For those who don't want to risk a time lag or a potential break-up of a trade (foregoing the opportunity for price improvement), the hybrid model will allow the investor to choose a black box automatic execution rather than a manual execution. The biggest beneficiary of eliminating this choice would be sell-side firms seeking to internalize order flow. There is no reason that a manual model and an electronic model cannot exist side-by-side indefinitely. In fact, the London Stock Exchange has for some time run the SETS all-electronic model along with a traditional market making model, with the latter still maintaining significant share and being integral to the price discovery process according to market observers.

Third, time and again, the end of the floor has been predicted, including advice Rich was offered when he was first considering taking a job on the floor in 1969 (the year Joe was born!), and proved wrong. We suspect that the old Mark Twain quip "The reports of my death have been greatly exaggerated" will once again prove true.

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