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# Motivations, Mechanics and Models for Exchange Demutualizations in the United States

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## 3.1 Overview

Stock and commodities exchanges traditionally operated in the form of non-profit mutual or membership organizations. To the extent market power was not curtailed by competition or regulation, mutual governance gave specialist or market maker members of an exchange control of the price, quality and range of services produced by the exchange. Exchange profits were returned to members in the form of lower access fees or trading profits. Also, exchanges operated as self-regulatory organizations (SROs) to enforce discipline upon members. Initially, this discipline included the fixing of commission rates.

Today some exchanges have been transformed into for-profit shareholder-owned companies and many more are considering such a demutualization. Some demutualized exchanges have become public companies and listed on their own or other boards. Others have remained privately held companies but intend to go public in the future. This chapter will discuss the United States experience and perspective with regard to why exchanges and similar entities have demutualized, how seats are transformed into shares and post demutualization models.

In many countries exchanges were created by state decree. In other countries they were organized as membership organizations from loosely connected traders who met in coffee houses or street corners. In the United States, exchanges pre-dated corporation and securities laws. The

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New York Stock Exchange (NYSE) was organized as a private membership organization in 1792 prior to the adoption of general incorporation statutes. Later NYSE became a not-for-profit corporation under existing New York law, but continued to be a membership organization. Before 1934, no analogue to stock exchanges for the over-the-counter (OTC) market existed, but in 1938 Congress passed a statute to establish a framework for an over-the-counter SRO.[2]

Only one such association, the National Association of Securities Dealers, Inc. (NASD) exists for over-the-counter (OTC) brokers and dealers. The NASD was organized as a not-for-profit membership corporation under Delaware law in 1939. Although NASD is for all intents and purposes a stock exchange, it continues to be called and regulated as an association under the securities laws, but the NASD's subsidiary, the NASDAQ Stock Market, Inc. (NASDAQ) is in the process of registering as a stock exchange. All broker-dealers registered with the Securities and Exchange Commission (SEC), except those doing business exclusively on a securities exchange, are required to join NASD. The Pacific Exchange (PCX), a regional stock exchange, was formed in 1957 as a merger of the San Francisco Stock and Bond Exchange (founded in 1882) and the Los Angeles Stock and Oil Exchange (founded in 1899). It began trading stock options in 1976.

In the United States, securities and commodities exchanges are separate and they are regulated for the most part by separate regulators. The Chicago Board of Trade (CBOT) is the oldest US futures exchange, established in 1848. The State of Illinois passed a special law in 1859 to facilitate incorporation by CBOT. The Chicago Mercantile Exchange (CME) is an outgrowth of the Chicago Produce Exchange, established in 1874 to provide a systematic market for butter, eggs, poultry and other farm products. It was incorporated under the not-for-profit law of the State of Illinois and was transformed into a financial futures exchange in the 1970s.

On 13 November 2000, the Chicago Mercantile Exchange (CME) became the first US exchange to demutualize. It is a registered and reporting company under the *Exchange Act* but it has not yet conducted a public offering. In May 2000 the SEC approved PCX Equities, Inc. (PCX) as the first US stock exchange to become a for profit stock corporation. NASD has transformed NASDAQ into a for profit stock corporation and sold a portion of its shares in a private placement. A future public offering of NASDAQ shares is contemplated. The CBOT is in the process of

[2] Securities Exchange Act of 1934 (Exchange Act), § 15A, 15 U.S.C. § 780-1.

obtaining membership approval for a demutualization and public offering. NYSE announced it would demutualize in 1999, but thus far it has not taken steps to do so.

Demutualization of exchanges is a response to global competition and technological innovation that is restructuring the securities markets. When an exchange changes from a mutual membership organization to a for-profit stock corporation, its corporate governance is transformed and it is in a better position to raise capital needed for technological improvement or business expansion. Demutualization requires the approval of an exchange's membership and its Government Regulator, so the process of turning seats into shares is complicated. Demutualization without a public offering generally is a transitional phase on the road to an exchange becoming a publicly-owned and traded corporation. Nevertheless, because of the key role that exchanges play in a capitalist economy with regard to capital formation, price discovery and allocation of capital, exchanges may not develop into ordinary public corporations.

## 3.2 Reasons for Demutualization

The primary driver for demutualization has been to meet competition from other exchanges, including non-traditional trading markets such as electronic communications networks (ECNs), or alternative trading markets (ATSs). This competition has put pressure on trading profits at a time when trading volumes have increased, but technology has made trading more efficient. In order to compete with ECNs, traditional exchanges have had to better align their governance and business strategies to satisfy institutional and retail customers rather than the short term interests of their members. One aspect of this realignment has been to give clearing members more influence than trading members.

Exchanges have set forth various reasons for their demutualization initiatives, and these statements are informative. CME identified five objectives[3] of its demutualization as follows:

- *Improved governance and managerial structure.* In the view of CME, the traditional distinctions between the exchange's activities and the

[3] See Amendment No. 5 to Form S-4 Registration Statement, 25 April 2000, available at <http://www.sec.gov/Archives/edgar/data/1103945/0000950131-00-002795.txt>.

activities of its members and clearing members were becoming increasingly blurred. Members and clearing members decided its affairs, but some of them competed directly with CME by developing off-exchange products and businesses and by joining alternative market initiatives. The board of CME believed that demutualization would enable management to reduce the impact of these conflicts, by creating a governance and management structure that is more agile and swift in its ability to respond to competition. Also, CME's enterprise value will be increased for the benefit of its equity owners. Management of the demutualized entity will be free to make decisions regarding listing contracts electronically, changing clearing and transaction fees when appropriate, or expanding existing product and service offerings.

- *Improved financial decision-making model.* Commercial decision-making will diminish member political influences. Commercial pricing of services and a profit-making objective will ensure that resources are allocated to those business initiatives and ventures that enhance, or have the potential to enhance, stockholder value. The CME's ability to obtain financing at favorable rates will depend on whether lenders believe it is investing prudently.

- *Create a catalyst for pursuing new business strategies.* Continuing financial innovation and demand for new risk management and derivative products are fueling global growth in exchange-traded and over-the-counter products. To capitalize on this potential, a demutualized CME will be able to attract outside investment, further expand its current technology platforms, and broaden its product and service offerings.

- *Unlock members' equity values.* Over the years, many retired CME owners experienced substantial declines in their seat values and turned to income from leasing. These owners have become generally less interested in member opportunity on the floor and more interested in maintaining their asset values and deriving income from their assets. They have become more like traditional stockholders than exchange members. Demutualization will unlock the equity value in CME memberships, and provide shareholder returns to them. Many of the members are interested in selling only a portion of their interest in the exchange, but these members have been unable to do so because they cannot sell less than an entire membership or seat.

- *Provide a signal and a currency for working with strategic partners.* Technology firms, as well as firms interested in acquiring an equity stake in CME, are likely to prefer to work with a demutualized corporation, rather than a member-owned mutual organization. Demutualization and conversion of memberships into shares will create a valuable currency for strategic alliances.

The Pacific Exchange (PCX) has expressed itself similarly.[4] It has asserted that the traditional structure is not readily adaptable to an emerging competitive environment. It is difficult to implement new policies and new strategic directions because members, acting through committees or voting on constitutional amendments, must bless each significant change. In addition, the cost of capital to member organizations is high. As a result, members, through fees, dues, and transaction charges, or through special assessments, become the primary source of working capital. Therefore, demutualization is a necessary step in modernizing governance and management for achieving growth in the future. Demutualization will allow PCX to unlock its equity value, enhance its business and partnership opportunities, and position the exchange to become more responsive to customer needs.

The demutualization plan is thought to provide the best opportunity for both members and seat owners to maximize value going forward. The goal of the proposed structure is to streamline decision-making, provide a more flexible capital structure, and separate the regulatory functions from other businesses. This structure will provide PCX with the ability to enter into strategic transactions by using its capital stock as a new form of currency, and enhance its ability to raise outside capital for technology innovation, product development and other critical initiatives.[5]

The Board of Directors of NASDAQ believed that it was in the interest of both its shareholders and the investing public for NASDAQ shares to be publicly traded and widely held through an IPO.[6] As a for-profit, stock-based company governed by the market's leading participants, NASDAQ would be more agile, flexible, and effective in responding to industry and

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4 *Moving Securities Exchanges into the 21st Century*, Remarks of Mr. Robert M. Greber, Chairman of the Board Pacific Exchange, Inc. Securities Trading on the Internet Conference New York, New York, 15 June 1999, available at <http://www.pacificex.com/about abt_public_sec_exch_21st.html>.

5 Pacific Exchange Board Approves Demutualization, Screen-Based Trading Plans, press release, 13 December 2000, available at <http://www.pacificex.com/about/press-2000/abt_press_00_dec_board.html>.

6 *NASDAQ to Become a Public Company*, available at <http://www.nasdaqnews.com/news/pr2001/ne_section01_140.html>.

market conditions. The advantages noted for a public ownership included the following:

- An IPO and the capital it provides will allow NASDAQ to continue to improve its market by allowing NASDAQ to compete effectively with domestic and international competitors, facilitating the NASD's sale of its remaining equity ownership, and creating a liquid acquisition currency for NASDAQ.
- An IPO will provide a valuation benchmark and liquidity for current investors. An IPO will allow NASDAQ to control the development of the trading market for its stock. NASDAQ's interest will be aligned with the interests of key participants. NASDAQ will have both an initial infusion of capital and easier ongoing access to capital.

The CBOT's demutualization is intended to modernize its corporate governance structure, improve the efficiency of its corporate decision-making process and position CBOT to compete more effectively in the evolving futures marketplace. As a for-profit stock corporation, CBOT will have the ability to issue capital stock, the flexibility to continue to evaluate the CBOT ownership structure and to consider value enhancing transactions in the future.[7]

The NYSE Chairman has explained that the diversity of interest among NYSE members is a continuous source of tension and conflict. Members are only able to realize economic value from their right to trade on the NYSE floor, but member firms compete with one another in a variety of businesses, including OTC market-making in listed securities. Demutualization offers greater commonality among equity owners and avoids concentration of ownership power in a particular group of exchange participants. Also, a demutualized exchange can raise capital for strategic affiliations, technological improvements or new systems.[8]

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7 See Amendment No. 4, Form S-4, CBOT Registration Statement, available at <http://www.sec.gov/Archives/edgar/edgar/data/1117463100009501310150 1062/ds4a.txt>.

8 Testimony of Richard A. Grasso Before the Senate banking Commission, 28 September 1999, available at <http://www.nyse.com/speech/NT0002458E.html>.

## 3.3 How Demutualization is Accomplished

Pursuant to demutualization plans, members are given trading rights that generally are coextensive with the rights held before demutualization. In addition, members and outsiders are given the opportunity to purchase capital shares. The complexity of any exchange's demutualization depends in part on how complex its membership structure was before demutualization, and what objectives the demutualization is designed to achieve. At the commodity exchanges, for example, different trading rights exist for different contracts. At some exchanges many seats are leased, and there are different economic interests between lessors, lessees and other members. The demutualizations of NASDAQ and PCX accomplished a separation of trading facilities and member self-regulation.

### 3.3.1 The Chicago Mercantile Exchange Demutualization[9]

The CME converted itself into a publicly held, for-profit corporation in several steps. The original Illinois not-for-profit corporation initially was merged into a new Delaware non-stock corporation and immediately thereafter into a stockholder-owned, for-profit Delaware corporation. In a final step, CME then issued Class A and Class B shares. Both classes of stock have the traditional features of common stock; however, the primary purpose of the Class B stock is to confer trading privileges associated with exchange membership. The transaction did not represent an Initial Public Offering (IPO).

As a result of the demutualization, 25,855,200 shares of Class A common stock were allocated on a 3-2-1 basis to members of CME, International Monetary Market (IMM) and Index and Option Market (IOM) divisions. In addition, 4,722 shares of Class B common stock were issued to exchange members in series corresponding to the former membership divisions. Each CME member received a B-1 share, each IMM member received a B-2 share, each IOM member received a B-3 share, each member of the Growth and Emerging Market (GEM) division received a B-4 share, and those holding a fractional interest in a GEM seat received a B-5 share. Each B series share confers the trading privileges associated with the membership interests that are converted into that series, along with the traditional features of common stock.

9 See Questions & Answers on the Demutualization of the Chicago Mercantile Exchange into Chicago Mercantile Exchange Inc., available at <http://www.cme.com/exchange/demutualizequestions.html>.

Class B shares are traded much the way memberships or "seats" on the exchange were traditionally bought and sold. CME's Membership Department posts bids and offers. The value of Class B shares, as determined by the market, are based on the value of the trading right and of the A share equivalents bundled with the trading right. Class A shares are subject to trading restrictions which will be lifted gradually over a period of 15 months after the demutualization transaction. For example, after six months, shareholders can trade 25% of their initially allocated Class A shares. For the first six months following demutualization, Class A shares can be sold only in conjunction with a sale of the related Class B share. Such sales will occur through a process substantially the same as the process for selling existing membership interests (i.e., through the Membership Department). After six months, increasing portions of the Class A shares can be transferred independently of the associated Class B shares.

The CME demutualization proceeded with over 98% of the membership in favor under the direction of a new CEO. It accomplished the transformation of CME into a for-profit corporation headed in the direction of becoming a public company.

### 3.3.2 The Pacific Exchange Restructuring and Transaction with Archipelago

The restructuring of the PCX proceeded differently with respect to its options trading and equities trading.[10] Regarding options trading, PCX's demutualization provided that PCX seat owners would retain an equity interest in the Exchange as well as the trading access privileges that each seat carried before. Specifically, seat owners received shares of voting common stock in a new company, PCX Holdings, Inc., (PCX Holdings) and a trading permit allowing them to trade on the PCX options floor. The existing PCX became a subsidiary of PCX Holdings, and it continues to operate the options trading floor and conduct associated regulatory functions.

The restructuring of equities trading is more complicated, involving both creation of equity trading permits (ETPs) to replace exchange seats and a merger transaction with Archipelago Holdings, LLC (Archipelago). First, a Delaware stock corporation, PCX Equities, Inc. (PCXE) was created

[10] Self-regulatory organizations; Notice of Filing of a Proposed Rule Change by the Pacific Exchange, Inc. and Amendment No. 1 Thereto Relating to the Archipelago Exchange, Release No. 43608, 65 Fed.Reg. 78822 (15 December 2000).

as a wholly-owned subsidiary of PCX to take over the equities trading and clearing business of the PCX. The PCX members received ETPs in the PCXE, in exchange for their seats on the PCX.

In addition, a merger transaction took place between the PCX and Archipelago. Archipelago was formed in December 1996 by a software developer and was one of the original four ECNs approved in January 1997 by SEC. In July 2000, Archipelago and the PCX closed a transaction creating the Archipelago Exchange (ArcaEx), the first totally open, electronic stock market in the United States.

The PCX and PCXE have entered into various agreements with Archipelago regarding the operation and regulation of its subsidiary, the Archipelago Exchange, LLC (Archipelago Exchange). Pursuant to these agreements, the Archipelago Exchange operates ArcaEx, which has replaced the PCXE's equity trading floor on 22 March 2002. ArcaEx is an electronic securities communications and trading facility allowing the ETP holders and their customers to trade stocks listed on the NYSE, American Stock Exchange (Amex) and NASDAQ.

Under the agreements, PCX and PCXE maintain responsibility for all regulatory functions related to the ArcaEx facility while Archipelago Exchange is responsible for the business of the facility to the extent those activities are not inconsistent with the regulatory and oversight functions of PCX and PCXE. As part of the transaction, PCX received an equity stake in Archipelago and an Archipelago representative went on the board of the demutualized PCX.[11]

The PCX's demutualization was primarily for the purpose of changing its business model and becoming an ECN.

### 3.3.3 The National Association of Securities Dealers Restructuring and NASDAQ Offering

In 1996, the NASD reorganized to create a parent holding company and two operating subsidiaries—NASDAQ and NASD Regulation, Inc. (NASDR). Thereafter, the holding company purchased the Amex. At a special meeting of NASD members held on 14 April 2000, more than a majority of NASD members approved a plan to restructure and broaden NASDAQ's ownership through a two-phase private placement of:

[11] *Archipelago and the Pacific Exchange Close Transaction to Create National Stock Exchange,* available at <http://www.pacificex.com/about/press-2000/abt_press_00_archipelago.html>.

(i) newly-issued shares of common stock, and (ii) warrants issued by NASD to purchase shares of common stock owned by NASD.[12]

In connection with the first phase of the restructuring, the NASD separated Amex from the NASDAQ-Amex Market Group, a holding company that was a wholly-owned subsidiary of the NASD, and the Group was then merged with and into NASDAQ. NASDAQ then effected a 49,999-for-one stock dividend creating 100 million shares of Common Stock outstanding (all of which were initially owned by the NASD), and authorized the issuance of an additional 30.9 million in new shares of Common Stock to be offered for sale by NASDAQ as part of the Restructuring. On 28 June 2000, NASDAQ sold an aggregate of 23,663,746 shares of common stock for an aggregate consideration of US$260,301,206. The NASD sold an aggregate of 6,415,049 Warrants to purchase an aggregate amount of 25,660,196 shares of common stock and an aggregate of 323,196 shares of Common Stock owned by NASD for an aggregate consideration of US$74,120,695.

In the second phase of the restructuring, on 18 January 2001, NASDAQ sold an aggregate of 5,028,797 shares of Common Stock for an aggregate consideration of US$65,374,361. The NASD sold an aggregate of 4,392,345 Warrants to purchase an aggregate amount of 17,569,380 shares of Common Stock and an aggregate of 4,222,295 shares of Common Stock owned by NASD for an aggregate consideration of US$116,382,665. Investors in both phases of this restructuring consisted of NASD members, NASDAQ market participants, issuers with securities quoted on NASDAQ, and other strategic partners.

On 3 May 2001, NASDAQ issued and sold US$240,000,000 in aggregate principal amount of its 4% convertible subordinated debentures due 2006 to Hellman & Friedman Capital Partners IV, L.P. and certain of its affiliated limited partnerships (collectively, Hellman & Friedman). The subordinated Debentures are convertible at any time into an aggregate of 12,000,000 shares of Common Stock, subject to adjustment. Hellman & Friedman owns approximately 9.8% of NASDAQ on an as-converted basis. In connection with the transaction, NASDAQ has agreed to use its best efforts to seek stockholder approval of a charter amendment that would provide for voting debt in order to permit Hellman & Friedman to vote on an as-converted basis on all matters on which common stockholders have the right to vote, subject to a 5% voting limitation in NASDAQ's Restated Certificate of Incorporation.

12 See NASDAQ 10-12G/A Registration Statement, June 29, 2001, available at <http://www.sec.gov/Archives/edgar/data/1120193/000095017201500449/0000950172-01-500449.txt>.

On 3 May 2001, NASDAQ used the net proceeds from the sale of the subordinated debentures to purchase 18,461,538 shares of Common Stock from NASD for US$13 per share for an aggregate purchase price of US$239,999,994. These repurchased shares have been cancelled and are no longer outstanding. As of 4 May 2001, NASD owns 31% of NASDAQ assuming all warrants are fully exercised.

The restructuring of the NASD is extremely complex because it involves a separation of NASD's regulatory functions from NASDAQ at a time when the US markets shifted to decimal trading and the over-the-counter market has been very volatile. The SEC's approval of various kinds have been required for the restructuring. This restructuring was a response to the challenges of ECN trading, and NASDAQ envisions that ECNs will become members of the new NASDAQ. The future of the Amex has yet to be determined.

### 3.3.4 The Chicago Board of Trade's Plans for Restructuring

Pursuant to its demutualization, the CBOT will be converted from a non-stock, not-for-profit corporation into a stock, for-profit corporation.[13] Each member will receive shares of Class A common stock in accordance with an allocation methodology of a share of one of the five series of Class B common stock in the for-profit corporation in respect of each membership held by such member. The shares of Class A common stock will represent an equity interest in the for-profit corporation. Each share of Class B common stock will represent an equity interest in the for-profit corporation and a membership in the demutualized exchange, which, subject to satisfaction of applicable membership and eligibility requirements, will entitle the holder to trading rights and privileges that correspond to the trading rights and privileges currently associated with that holder's class of membership.

In connection with the restructuring transactions, the membership petition process will be substantially eliminated and a more modern mechanism for initiating and voting on stockholder proposals will be adopted. The board of directors will be streamlined and modernized. In addition, the electronic trading business will be reorganized and consolidated into a wholly-owned subsidiary, Electronic Chicago Board of Trade, Inc. Full members and associate members will be entitled to vote on the restructuring transactions. Full members will be entitled to

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[13] CBOT Amendment No. 4 to Form S-4 Registration Statement, 2 May 2001, available at <http://www.sec.gov/Archives/edgar/data/1117463/000095013101501062/ds4a.txt>.

one vote for each full membership owned and associate members will be entitled to one-sixth of one vote for each associate membership owned. No other class of membership will be entitled to vote on the restructuring transactions.

The restructuring of CBOT is still on the drawing boards and it is another effort by this exchange to deal with the challenges of electronic trading and the globalization of the markets.

## 3.4 Post-Demutualization Models

One of the primary motivations for demutualization of an exchange is to change its governance. In the United States, both securities and commodities exchanges are required by law to have public directors. In 1975, the Exchange Act was amended to provide that the rules of an exchange or association must assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer. The *Commodities Futures Act* was similarly amended in 1992 to require exchange boards to provide for a meaningful representation of a diversity of interests. As a result of these legal requirements and for historical and political reasons, exchanges and the NASD have for some time had large boards which are comprised of 20% to 50% public members and the remainder of the board are members of the securities or commodities industries. Further, various constituency groups such as specialists, wire houses, floor brokers, institutional firms and commodities producers are represented on these boards. Independent nominating committees select board members. In addition, industry committees play a large role in exchange decision making.

After exchanges demutualize, they become more like other for-profit corporations where large investors may select board members and professional managers become the key decision makers. It is planned that their boards will become smaller and more focused on the profitability of the exchange, rather than the interests of members. Under CME's new governance, the board has been reduced from 39 to 19 members and will be further reduced to 10 members. Class B shareholders, representing the interests of members rather than owners, will have voting rights to elect only about 10% of the new board. Another example of governance change is at NASDAQ, where Warren Hellman of

Hellman & Friedman LLC, a private equity investment firm that made a significant investment in NASDAQ, was elected to the board in May 2001.

Most exchanges have conducted their demutualizations as private placements, but plan to make public offerings when such an offering is feasible as a regulatory matter and when market conditions permit. NASD, for example, has stated that it will sell by 30 June 2002 those shares of common stock it owns (other than shares underlying its warrants), subject to market conditions and its ability to obtain a fair price. But NASDAQ cannot become an independent public corporation until its registration as an exchange is approved by the SEC.

Whether exchanges can be transformed into ordinary public companies is an interesting question. Exchanges are much more than marketplaces for trading securities and commodities. They are quasi-public bodies that function as SROs. In the United States and elsewhere, they are treated as national champions.

If an exchange becomes an ordinary public company it will become subject not only to the advantages of public ownership, but also to the perils and burdens of such a business, and this is an unaccustomed mode of operation. Publicly-owned exchanges will have to make fuller disclosure of their financial condition and business operations than they do today and they will become subject to the pressures of investors to realize shareholder value. They will have to learn to deal with security analysts. Executives might become overly focused on stock price and begin to follow short term instead of long term strategies. They could become the targets of a hostile takeover initiative or a bidder in a losing acquisition effort. This already happened with respect to the OM Gruppen bid for the London Stock Exchange. If there is a market break and the stock price of an exchange falls this could accelerate investor loss of confidence in the market generally. Many exchanges have a smaller capitalization than some of their members and listed companies, but they have a mystique that places their trading activities on the newscreens every day. As public companies struggling for profits and market share exchanges could lose that mystique. However, that may be the price of survival in the stock markets of the future.