Taking stock of, and in, the New York Stock Exchange

By Adam Shell, USA TODAY

NEW YORK — Billions of shares of stock trade daily on the famous floor of the New York Stock Exchange. But for the first time since this capitalist icon was born in 1792 under a Buttonwood tree on Wall Street, investors today can buy and sell shares of the exchange itself.

The new company, NYSE Group, makes more use of computers in trading.

By Stuart Ramson, AP

In a move designed to boost its competitive edge against electronic rivals, the Big Board says goodbye today to its non-profit status and becomes a publicly traded company. The NYSE is shedding its image as a private club and merging with Archipelago, an upstart all-electronic exchange that didn't exist 10 years ago. (**Photo gallery:** New York Stock Exchange)

The new, profit-driven firm, valued at roughly $10.2 billion, will be called NYSE Group and trade under the symbol NYX on the Big Board. Its shares will trade just like other corporate giants, such as IBM and Coca-Cola.

Overnight, the NYSE goes from an exchange dominated by human brokers to one that offers investors a choice of executing trades with or without human intervention.

Drastic changes at the venerable institution — best known for its human-touch, auction-style stock trading — are necessary if the NYSE is to survive in a cut-throat trading world increasingly dominated by computers. "This is an historic day for the Exchange, our customers, and investors," CEO John Thain said in a statement Tuesday. "This merger transforms and modernizes the NYSE with a growth strategy for the future."

In recent years, the NYSE, the world's largest stock exchange, has come under attack. Competing stock markets, such as the Nasdaq, and electronic communication networks, or ECNs, have been stealing listings and trading volume. Mutual funds have been clamoring for faster, anonymous electronic trades. Regulatory reforms, such as a rule that orders be filled at the best price no matter which exchange posts it, have whittled away at the NYSE's once monopoly-like position. The global trend of exchanges going public has also resulted in more deep-pocketed, diversified rivals.

"The NYSE used to be the only game in town. But market forces are threatening its way of life. Electronic exchanges are cheaper, faster and can operate 24/7," says Timothy Pollock, an associate professor at Penn State University.

In response to that competition, the NYSE is broadening the scope of its 213-year-old business model. The goal: to remain relevant in a world in which trades are increasingly executed in milliseconds.

"It's a brilliant move for the NYSE," says James Angel, a finance professor at Georgetown University. "It takes out a potent competitor" in Archipelago and instantaneously boosts the Big Board's electronic trading clout and business volume.

The NYSE's move is part of a long-term growth strategy. A key goal of the merger is to give investors access to multiple trading platforms and a broader array of investment products to trade, such as options, futures, bonds, Nasdaq stocks and exchange-traded funds (ETFs). Similar diversification is found in thriving for-profit exchanges in Europe, such as the Deutsche Börse and Euronext.

Going public will speed the NYSE's decision-making. With more consolidation expected, it will be able to use its stock as currency to buy other exchanges.

But the deal is not free of peril. Unforgiving investors, Angel says, will be scrutinizing the NYSE Group's every move, making sure it's doing everything it can to maximize profit, integrate new technologies and marry two very different corporate cultures.

Behind-the-scenes impact

Aside from giving them the ability to own a piece of the NYSE, the deal won't have a dramatic impact on individual investors, because the mechanics of trade execution occur behind the scenes, out of plain view.

However, academics and analysts say investors will benefit from better trade executions and lower trading-related fees, thanks to improved efficiencies.

"When trading spreads (the gap between the seller's price and what a buyer wants to pay) get smaller and trades happen faster, the return for investors is going to go up," says Mike Pagano, professor at Villanova University's College of Commerce & Finance.

Adds Vincent Phillips, CEO of CyberTrader: "It's all about automation. When an investor sees a quote to buy a stock for $22.10 and the order gets filled at $22.10, that gives investors a ton of confidence."

The new entity will have a market capitalization of $10.2 billion, more than three times the market value of Nasdaq. The 1,366 former NYSE seat holders will profit well. Each seat gets 80,177 shares of the new company, $300,000 in cash, and a special dividend of $70,571. The total take per seat: $5.52 million. In contrast, a NYSE seat cost less than $1 million in January 2005 and $4 million at its peak in December. Archipelago shareholders, who will control 30% of the company, get one NYX share for each Archipelago share.

This deal is not a traditional initial public offering, or IPO, as Archipelago was already trading as a public company. There is no offering price, or initial price at which shares are made available to the public. Instead, a good proxy for where shares will start trading today is the $64.25 that Archipelago closed at Tuesday when it stopped trading for good under the AX symbol, says Richard Herr, analyst at Keefe Bruyette & Woods. Upbeat investors have been pricing in the merger's anticipated benefits since it was announced on April 20, 2005. Since then, shares of Archipelago have soared 242%.

Teaming with Archipelago, which will remain a separate exchange, allows the NYSE to create new revenue streams in addition to its current big-three moneymakers: the fees it charges for stock listings, transactions and market data.

The NYSE picks up Archipelago's roughly 22.3% share in the trading of Nasdaq-listed stocks. Prior to the deal, the NYSE traded only NYSE-listed stocks. It also gains a toehold in the options business and Archipelago's 35% share of trading in fast-growing ETFs.

Another plus: Firms that don't meet the NYSE's stringent listing standards won't need to go to the Nasdaq anymore. Instead, they can list shares on Archipelago. That creates another source of income for NYSE Group and makes it easier for smaller players to move to the NYSE once they mature.

Just as technology has revolutionized how people communicate, shop and work, it is driving change in financial markets. "This deal represents a sea change in the way markets will be viewed," says Bill Yancey, CEO of Penson Financial Services. "It's becoming a technological arms race. Whoever has the best technology gets there first" and has a trading advantage.

Until now, most NYSE trades were executed via an auction system that requires human negotiation between market makers, or "specialists." On average, a trade via the auction system takes 12 seconds, vs. three-tenths of a second to trade electronically via the NYSE's new handheld trading devices. Trades via Archipelago take less than a quarter of a second.

Price to be determined

Investors are hoping the NYSE enjoys the bullish reception that Archipelago, options exchange CBOT Holdings and other exchanges did after they went public. Archipelago has soared 459% since its August 2004 IPO, and CBOT is up 125% since its October IPO.

But the big run-up in Archipelago shares since the merger was announced 10 months ago might signal that further upside is limited, says Georgetown's Angel. "All the benefits of the deal," he says, "may already be reflected in the price." The stock, Herr says, is trading at 46 times 2006 earnings and 30 times next year's estimated earnings. More than $7 billion in value has been created since the deal was announced.

Wall Street analysts seem to agree. Six cover Archipelago. None rate it a "buy." Three rate it a "sell."

Still, Michael Cuggino, manager for Permanent Portfolio funds, says the stock is likely to attract lots of investor attention because it will be "an instant leader in its field. It will have all the characteristics of a hot IPO."

NYSE might sell additional shares in a secondary offering later this month or in April. That's when Big Board members who want to sell part or all of their equity stake might be able to do so.

Like most mergers, there are challenges and anxieties that come with the task of melding two separate business models with different corporate cultures.

Angst is being felt by the NYSE's army of specialists and floor brokers who make their living buying and selling stocks face to face. The meteoric rise of electronic trading has sparked a debate as to whether human intervention is even necessary, and whether the auction system will one day be extinct. "Any uncertainty spells jeopardy" for the specialists, says Robert Schwartz, a finance professor at Baruch College.

To combat that perception, the NYSE is currently in the early stages of implementing a "hybrid" trading system which combines the best the auction system has to offer with the obvious benefits derived from super-fast electronic execution. The hybrid system gives traders the choice of how they want to trade.

On the NYSE floor recently, Doreen Mogavero, a longtime exchange member and CEO of Mogavero Lee, admits that the thought of computers taking over crosses her mind. But she's confident the deal won't hurt or undermine her well-established business. Clients, she believes, will continue to view the role floor brokers and specialists play in working difficult trades, negotiating better prices and minimizing volatility as a key, value-added service.

For the most part, small trades and transactions involving very liquid stocks will be filled electronically. But human negotiations will remain key for certain kinds of transactions: big trades involving thousands of shares; smaller stocks that are less liquid and trade infrequently; and volatile situations in which stock prices zigzag violently due to, say, negative news headlines.

For those reasons, Mogavero thinks her business will continue to thrive. "If every clients' needs were the same, if every stock were the same, if every trade were the same," says Mogavero, that would worry her. Still, she says, "We're going to a place we have not been before."

Floor broker Robert McCooey, another NYSE member and CEO of The Griswold Co., says the deal not only offers investors more choices, it also gives human traders a chance to show how valuable they really are. "This is an opportunity for us to demonstrate that we are not dinosaurs," McCooey says.