

An hourglass-shaped graphic with a globe in the top bulb and another globe in the bottom bulb. The hourglass is light blue and has a dark blue top and bottom. The globe in the top bulb is dark blue, and the globe in the bottom bulb is light blue. The hourglass is centered on the page.

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Nasdaq's Pursuit of Exchange Status and an Initial Public Offering

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Abstract. In March 2001, Nasdaq submitted an application for exchange status to the Securities and Exchange Commission (SEC), an application that has been amended several times to address certain criticisms. Obtaining exchange status is necessary for Nasdaq to proceed to stage three, the issuance of publicly held stock. Realization of that stage became much closer on January 13, 2006, when after more than a half decade, the SEC approved Nasdaq's application to become a registered national securities exchange.

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Nasdaq's Pursuit of Exchange Status and an Initial Public Offering

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Summary

Traditionally, the Nasdaq stock market was a for-profit, but wholly-owned subsidiary of the nonprofit National Association of Securities Dealers, Inc. (NASD), the largest self-regulatory organization (SRO) for the securities industry. In 2000, in a strategic response to an increasingly competitive securities trading market, the NASD membership approved spinning off the for-profit NASD-owned Nasdaq and converting it into a for-profit shareholder-owned market that later planned to issue publicly traded stock. For Nasdaq, this process has involved three basic stages: (1) issuing privately placed stock; (2) converting to technical exchange status; and (3) issuing publicly-held stock. Stage one, the private placement stage has been completed. In March 2001, Nasdaq submitted an application for exchange status to the Securities and Exchange Commission (SEC), an application that has been amended several times to address certain criticisms. Obtaining exchange status is necessary for Nasdaq to proceed to stage three, the issuance of publicly held stock. Realization of that stage became much closer on January 13, 2006, when after more than a half decade, the SEC approved Nasdaq's application to become a registered national securities exchange.

Introduction

Established in 1971 at the request of the SEC, the Nasdaq stock market is an all-electronic trading facility, which, unlike traditional exchanges like the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX), has no trading floors and facilitates the trading of over-the-counter (OTC) stocks through a network of market makers connected by telephone and computer. Nasdaq stock market was originally a wholly-owned for-profit subsidiary of the nonprofit NASD, which also served as its direct regulator or self-regulatory organization (SRO).

In the mid-1990s, NASD's integrity as a self regulator was called into question when Nasdaq market makers were accused of manipulating stock prices. After a federal investigation, the NASD Regulation (NASDR) was established in 1996 as an independent subsidiary of the NASD. The main purpose was to separate the regulation

of the broker/dealer profession from the operation of the Nasdaq. The NASDR became the primary regulator of broker-dealers and of the Nasdaq. All broker-dealers who are registered with the SEC, except those doing business exclusively on a securities exchange, are required to join the NASD. The NASDR's regulatory budget is derived solely from fees and fines imposed on NASD member firms.

When it began, Nasdaq was regarded as a technological innovator because it did not rely on a physical trading floor. But over the last decade, both Nasdaq and traditional exchanges have faced growing competition from two principal sources: First, global stock markets that compete with U.S. markets for multinational corporate listings have grown dramatically. Second, continuous technological change has led to automated, computer-matching, trading platforms called electronic communication networks (ECNs). Indeed, Nasdaq has developed its own ECN, the SuperMontage and has acquired another one, Brut.

To help themselves remain competitive, the world's major stock markets are reexamining their governance and capital structures with an eye toward changes that would enable them to react more deftly to the rapidly changing securities marketplace. Conversion from privately-held (mutual) status to shareholder-owned status known as demutualization, has become an increasingly attractive strategic response to the changing market dynamics.

Many international and domestic stock exchanges have demutualized over the last decade or so, including the London, Tokyo, Philadelphia, and the New York Stock Exchange (in early 2006 after merging with Archipelago, the electronic communication trading network). Key reasons for demutualization have included that (1) it enables exchanges to more immediately raise capital and provide better regular access to capital markets;¹ (2) it makes exchanges better able to align their interests with those of their key participants; and (3) it provides exchanges with greater flexibility and speed in adapting to changing market conditions.

SRO Concerns Raised by Demutualization

In the summer of 1999, the Nasdaq announced its intent to demutualize. This change raised a number of policy concerns that largely involved demutualized stock markets' ability to effectively discharge their SRO duties. Among the key questions raised by the prospect of demutualization were (1) Is there a cause for concern when a for-profit, shareholder-owned SRO regulates entities like broker-dealers who in turn have ownership stakes in competitive rivals such as electronic communication networks? and (2) Would the altered economics of being a for-profit, shareholder-owned exchange affect an exchange's ability to effectively regulate itself?

¹ In the spring 2005, in an acquisition that may foreshadow future acquisitions, Nasdaq announced an agreement to purchase Instinet's electronic communication network and to consolidate their trading platforms.

Nasdaq's Demutualization and Approval as an Exchange

After announcing its interest in pursuing demutualization, the NYSE cited other pressing concerns and put the process on hold. In April 2000, however, the NASD membership approved spinning off the for-profit Nasdaq from the non-profit NASD and converting it into a shareholder-owned market. The process was initially envisioned to have three broad stages: (1) issuing privately placed stock; (2) converting to technical exchange status; and (3) issuing public stock.

The private placement took place in two sub-stages. In the initial sub-stage, the private placement, which was completed in June 2000, the NASD sold shares and issued warrants on shares of Nasdaq that it owned, and Nasdaq also issued and sold additional shares. The NASD's ownership interest in Nasdaq was reduced from 100% to 60%. The second sub-phase of the private placement was completed on January 18, 2001, with NASD's ownership interest then falling to 40% or about 77 million Nasdaq shares. The NASD, however retained 51% of the actual voting interest in Nasdaq. On February 21, 2002, Nasdaq acquired 13.5 million shares held by the NASD. On March 8, 2001, Nasdaq acquired 20.3 million shares from the NASD, leaving 43.2 million shares still owned by the NASD in the form of underlying warrants that had been issued during Nasdaq's private placements. Concurrently, a new series of preferred voting stock was issued to the NASD, allowing it to continue to have majority voting interest in Nasdaq.

The second stage, conversion to exchange status, was a requirement for the third stage — sale of Nasdaq shares to the public. Although from a practical standpoint it has little significance, Nasdaq currently is exempt from the definition of an “exchange” under Rule 3a1-1 of the Securities and Exchange Act of 1934 because it is operated by the NASD. Before the NASD could relinquish control of it, Nasdaq was required to register as a national securities exchange. With approval of Nasdaq's exchange application, the preferred shares that provide the NASD with its majority vote interest over Nasdaq will expire and it will no longer have effective control over Nasdaq. The exchange's ultimate goal has been to conduct an initial public offering (IPO).

On March 15, 2001, Nasdaq submitted an initial application for exchange status to the SEC, an application that the agency published for comment on June 14, 2001. It later made several amendments to the application in late 2001 and early 2002. After the initial application, the foremost regulatory concern for the SEC and a number of securities market participants was that, as written, the application would have continued to allow Nasdaq to operate without a trade execution protocol known as intra-market price and time priority, which is required of exchanges. This protocol is described below.

Nasdaq processes limit orders, orders to buy or sell a stock when it hits a specified price. The NYSE centrally posts limit orders, which permits better-priced orders to receive priority execution there or on the various other interlinked market centers that trade NYSE-listed stocks. This is known as price and time priority and all exchanges abide by it. (Both the Nasdaq and the NYSE are markets in which brokers are required to exercise their duty of best execution when they route their customer's orders. The concept is inexplicit but is often interpreted to mean that an order should be sent to the market center providing the best prevailing price.)

But a significant fraction of Nasdaq market makers match buyer and seller orders from their own order books. Known as internalization, this can result in well priced limit orders outside of a market maker's book being ignored. Nasdaq officials have argued that their market permits competing dealers to add liquidity to the markets by interacting with their own order flow but SEC officials have concerns about the formal absence of price priority. This was a major sticking point in the agency's delay in approving the exchange application, concerns that Nasdaq attempted to address through subsequent amendments to its exchange application.

On January 13, 2006, the SEC approved Nasdaq's application to become a registered national securities exchange. As a registered exchange, Nasdaq will become a self-regulatory organization (SRO) with ultimate responsibility for its own and its members compliance with the federal securities laws. Several years ago, Nasdaq entered into a Regulatory Services Agreement with the NASD to perform certain key regulatory functions for it, an arrangement that should continue.

Nasdaq is now officially a registered an exchange, but the SEC will not permit Nasdaq to begin operations as an exchange and to fully relinquish its independence from ongoing control by the NASD until various conditions, including the following key ones, are satisfied:

- Nasdaq must join the various national market system plans and the Intermarket Surveillance Group;²
- The NASD must determine that its control of Nasdaq through its Preferred Class D share is no longer necessary because NASD can fulfill through other means its obligations with respect to non-Nasdaq exchange-listed securities under the Exchange Act;
- The SEC must declare certain regulatory plans to be filed by Nasdaq to be effective; and
- Nasdaq must file, and the Commission must approve, an agreement pursuant to Section 17d-2 of the Securities Exchange Act of 1934 that allocates to NASD regulatory responsibility with respect to certain activities of common members.

Nasdaq's exchange application limits the exchange to transactions in the Nasdaq Market Center, previously known as SuperMontage and Brut, which will adhere to rules on intramarket priorities. However, orders that are internalized by NASD broker dealers that may not adhere to intra-market priority rules would be reported through the new Trade Reporting Facility (TRF), which must go through a separate regulatory review

² The National Market System (NMS) is composed of the various systems that govern the communication links among domestic stock exchanges. The NMS plans are the various rules that govern the linkages. The Intermarket Surveillance Group was created in 1983 by the major U.S. securities exchanges to provide a consistent protocol for the exchange of information across the different securities trading jurisdictions.

process and which will be administered by the NASD. Nasdaq will receive revenues from TRF trades (a contentious point for a number of its rivals).