

CRS Report for Congress

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

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Summary

Until recently, 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. The process has three broad 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). Obtaining exchange status is necessary for Nasdaq to proceed to stage three of Introduction, its conversion to an independent shareholder owned market — a public stock offering. A major reason that the SEC continues to hold up Nasdaq's exchange application is that exchanges must comply with a trading protocol in which they provide execution priority to the best priced offers to trade known as price priority. As an association and not an exchange, Nasdaq is not beholden to such a rule. And SEC officials have been reluctant to grant it exchange status without a price priority trading protocol, which Nasdaq officials say is an intrinsic and beneficial part of its business model.

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 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.

Occurring in growing numbers of stock exchanges worldwide, demutualization appears to be attractive for three central reasons: (1) it would enable exchanges to more immediately raise capital and provide better regular access to capital markets; (2) exchanges would be better able to align their interests with those of their key participants and; (3) probably most importantly, it would provide exchanges with greater flexibility and speed in adapting to changing market conditions.

In the last several years, the Chicago Mercantile Exchange and the the Philadelphia Stock Exchange have demutualized. In addition, the Pacific Exchange demutualized its equity business, allowing it to align with the ECN Archipelago, which became ArcaEx.

SRO Concerns Raised by Demutualization

In the summer of 1999, the Nasdaq and the NYSE announced their intent to demutualize. A debate largely on demutualized stock markets' ability to effectively discharge their SRO duties ensued in Congress, the SEC, among some academics, and various members of the financial community. Among the key questions raised were the following: (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 ECNs? and (2) Would the altered economics of being a for-profit, shareholder-owned exchange affect an exchange's ability to effectively regulate itself?

Nasdaq's Demutualization

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, is a requirement for the third stage — sale 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 can relinquish control of it, Nasdaq must register as a national securities exchange. The NASD's majority voting interest is currently voted by a trustee at its behest. 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). And according to some Nasdaq officials, an IPO in which the voting rights are still controlled by another entity (currently the NASD) would probably have diminished appeal.

Approval of Nasdaq's exchange application would also mean that the stock market would become its own SRO, legally independent of the NASD and on the same legal footing as the other domestic exchanges. On March 15, 2001, Nasdaq submitted its 8,000 page application for exchange status to the SEC, an application that the agency published for comment on June 14, 2001. As a group, ECNs have been rather critical of the application. Criticism has also come from other interests, including the NYSE and the Securities Industry Association (SIA), a major association of securities firms. And citing some concerns, the SEC has delayed acting on the exchange application. Its core concern is described below.

Some Responses to the Exchange Application

The NASDR is currently contracted to perform regulatory functions for Nasdaq under the auspices of the NASD, which has SRO responsibility over Nasdaq. Nasdaq officials say that NASDR will continue its contracted SRO relationship with the stock market. With receipt of exchange status, however, Nasdaq would move from under the NASD/NASDR self-regulatory-organization umbrella and be ultimately responsible for its own SRO obligations, its members, and its operations.

A number of the concerns expressed in the comments on Nasdaq's exchange application have related to the potential ramifications of such a change. Other comments involved concerns over the absence of key data on Nasdaq's post-exchange structure, and issues surrounding Nasdaq's proposed membership rules. Among those issues were the following: (1) Given some observers' perception that SROs have had a history of favoring certain segments of their membership over others, or of ignoring potential misconduct that benefitted the SRO or its members, there were concerns that giving Nasdaq for-profit, shareholder-owned exchange status might impair its ability to effectively and impartially carry out its SRO functions. (2) Nasdaq was also criticized for its perceived failure to disclose important information about its post-exchange trading rules and its corporate governance methods. (3) Nasdaq's new proposed membership rules were criticized for requiring a Nasdaq member to be a member of at least one other self-regulatory organization before it could apply for membership in Nasdaq.

SEC Concerns Over the Exchange Application and Some Congressional Responses

The SEC has now had the Nasdaq exchange application for several years. The central hold up is over the agency's concern with how 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 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 argue 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 is a major sticking point in its reluctance to approve the exchange application. Exchange officials are also concerned that if they provide Nasdaq with an exemption from price priority, other exchanges will ask for the same, potentially resulting in a "race to the bottom" among exchanges.

During the 108th Congress, a number of Members spoke of their concerns that the SEC was dragging its feet on Nasdaq's application. They included the Honorable Richard

Baker, chairman of the Capital Markets Subcommittee of the House Financial Services Committee, and the Honorable Michael Enzi who is now chairman of the Senate Health, Education, Labor and Pensions Committee.

In December 2004, SEC staffers announced that they were optimistic about having reached a breakthrough on Nasdaq's long-pending exchange application and that they would be presenting the plan to the full commission.