The founder and CEO of Archipelago Holdings, Inc., creates a business model so powerful that the world's mightiest stock exchange had to join it or risk extinction.

Equities Achiever of 2005: Gerald D. Putnam

BY ART DETMAN

For each of the past 34 years, starting in 1972, EQUITIES Magazine has honored the person we feel has done the most to improve the equities market during that year. The efforts of the winners, and naturally many more who are never honored, are one reason America's equity markets continually become safer, more efficient and more attractive for investors. Despite all the problems, past and present, our capital markets are still the envy of the world.

For 2005, our choice is Gerald D. Putnam, founder and—until its merger with the New York Stock Exchange—chief executive officer of Archipelago Holdings, Inc. Educated as an economist and accountant, Putnam entered the securities business in 1983. A maverick who didn't fit in; he once even got himself fired. Not liking what he saw, he was determined to change the trading world. He did. In 1994, he founded an online broker/dealer, Terra Nova and continued as its president even after he founded Archipelago. Today, the 47-year-old Putnam is president and chief information officer of the NYSE Group, Inc.

If you had to describe Gerald D. Putnam in two words, "visionary" and "determined" would do. More than anyone except John Thain—CEO of the NYSE Group, Inc. and, as head of the New York Stock Exchange, 2004's EQUITIES Achiever—Jerry Putnam is responsible for bringing the New York Stock Exchange into the electronic era.

The creation of the NYSE Group ended the Big Board's 213-year history as a mutual enterprise owned by fiercely loyal seat holders and famed for its open outcry method of buying and selling stocks on its often photographed trading floor.

To be sure, the floor traders in their colorful smocks are still there, still shouting out buy and sell offers to specialists, but both traders and market makers know that they are an endangered species. The Big Board, like Archipelago, is now part of the NYSE Group, to be traded under the utilitarian symbol NYX.

NYSE Goes Electronic

Even before the merger, the Big Board electronically matched as much as 10% of its daily trades. It will never go to 100% because some thinly traded but high-priced stocks (think Berkshire Hathaway) are best traded by real people face to face. Still, the journey to a nearly complete electronic exchange is well under way. One day, the sound of stocks trading at the NYSE will be primarily the clicks of keyboards and the hum of computers.

Jerry Putnam understood this in 1996 when the SEC issued its revolutionary new Order Handling Rules. Suddenly, electronic communications networks (ECNs) could interact directly with Nasdaq's National Market System. He founded Archipelago that December, and in January 1997 it became one of the four original ECNs approved by the SEC.

By 2005, Arca (as the multisyllabic Archipelago is widely known) and Instinet dominated ECN trading. Big institutional investors like mutual funds and, especially, hedge funds value using the ECNs for their near-instant executions. A trade on the Big Board takes an average of 12 seconds, plenty quick for most individual investors, but agonizingly long for the big boys whose computers can place and cancel an order several times a second.

One result was that the NYSE was steadily losing market share in Big Board-listed stocks. In just a few years, the NYSE's share has fallen from over 90% to as low as 75%. Such steady erosion threatens Big Board income in three ways. First, of course, is the loss of trading fees. Second, involves the data that the exchange compiles and sells; a smaller market share diminishes the value of this data. Together, these two businesses generate almost as much revenue as the annual listing fees, which also are endangered by falling market share. As a stock's trading volume shifts from the NYSE to other venues, the issuing company may well question the need to keep paying those yearly listing fees.

For example, in December Charles Schwab Corporation, which was listed on both Nasdaq and the Big Board, switched to an exclusive Nasdaq listing at an annual estimated savings of $400,000. With a market cap of $19 billion, Schwab was by far the largest of the dual-listed companies to leave the NYSE.

In early 2005 Nasdaq, the midtown Manhattan rival to Wall Street's Big Board, moved to acquire Instinet for $1.9 billion. On April 20, Putnam and Thain responded by announcing that Arca and the NYSE would join forces in what was then a $6 billion deal.

It was not a preordained combination, for Putnam had often disparaged the Big Board for its antiquated and sometimes opaque or even self-serving practices. "In 1997 we were the first equity market to introduce a best-execution model to obtain the best price for investors," he told AX shareholders. "And we launched the nation's first totally open, fully electronic stock exchange in 2002." Indeed, again and again Putnam emphasized that Arca's first priority is, in his words, "to provide an open, transparent and fair marketplace for all investors." Arca even copyrighted this catch phrase: "Archipelago. Everything out in the open."

The terms of the merger agreement called for Big Board members to own 70% of the resulting company. In addition, each seat holder would receive $300,000 cash. Immediately, the price of Big Board seats started to rise sharply, as did the price of Arca stock (which traded under the AX symbol, mainly on the Arca-owned Pacific Exchange).

An NYSE seat, which sold for as little as $975,000 in January '05 went for $1.6 million on the day the proposed merger was announced. Then, it climbed to a record high of $4 million just prior to the merger's approval. Meanwhile, AX—which languished at a 52-week low of $15.20 prior to the merger announcementmore than tripled in price, reaching $60.38 two days before the vote on December 6. (Recently the stock was trading at $53.04).

The Future of NYX

Despite the run up in the price of a seat, there was vociferous opposition to the merger from the start. Warren Buffet didn't like it and a seat holder sued. In a winning compromise, the Big Board paid Citibank $3.5 million for a fairness opinion, which said, yes, the 70/30 deal—by then worth $9 billion —was fair.

Of the Big Board's 1,366 members, more than 90% cast a vote, roughly 95% in favor of the merger. Founded under a buttonwood tree in 1792, the New York Stock Exchange was suddenly thrust into the 21st Century. Many members cheered, some cried, and a few cursed, but all felt a strange sense of loss.

For Putnam, he lost control of his company but the once maverick became not only president and CIO of the NYSE Group but a major shareholder. As 2005 drew to a close, he owned 1.3 million shares of AX, worth about $69 million.

A key question for Putnam and his fellow NYSE Group shareholders is once NYX shares start trading on the open market, what value will investors place on them? After all, despite Arca's unquestioned success, its share of OTC trades fell from 22% in '03 to 20% in '04 and 17% in '05. What's more, former NYSE members are expected to sell $1 billion worth of stock early in 2006, which could drive down the price substantially.

Then again, NYX has the ability to use its stock to acquire other international exchanges and related enterprises, and can make decisions quickly instead of obtaining a broad consensus. With these abilities and a newfound entrepreneurial spirit, NYX may have surprising growth potential. In any event, the publicly traded NYSE Group, Inc. will be an even more powerful force for change in the securities market than was the member-owned Big Board. And much of the credit must go to the EQUITIES Achiever of 2005, Jerry Putnam.