

*Futures Shock***Chicago Merc to Buy Board of Trade****Linkup of Old Rivals Shows Fast Rise of Derivatives And Electronic Trading****Biggest Yet in a Merger Wave**

By AARON LUCCHETTI, ALISTAIR MACDONALD and EDWARD TAYLOR
October 18, 2006; Page A1

The **Chicago Mercantile Exchange Holdings** Inc. and the Chicago Board of Trade agreed to join forces to form the world's largest financial market, one that will dwarf exchanges in the U.S. and Europe -- even the New York Stock Exchange.

The Chicago Merc announced plans to buy the smaller **CBOT Holdings** Inc. for about \$8 billion. As the biggest deal yet in a global consolidation of the financial-exchange industry, the plan sets aside more than a century of crosstown rivalry.

MORE OF THE DAY'S TOP IMAGES

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Traders in the Eurodollar options pit of the Chicago Mercantile Exchange after the Fed rate news late last month.


of eggs, butter and corn, the Chicago exchanges, together, will trade some nine million futures contracts a day. Futures contracts give investors the right to buy or sell something later at a set price. Thus, they are used to hedge risk, allowing investors to enjoy smoother growth of their assets without the bumps that come with simpler investments on, say, a portfolio of stocks.

"Chicago used to be known as the hog butcher of the world. The city now will be known as the world's risk manager," said John F. Sandner, a Chicago Merc board member.

Futures have also become tools for making investment bets: on commodities such as wheat or oil, on trends in the economy and on broad measures of the stock and bond markets. Futures contracts can be tied to price movements of stock indexes, bonds, interest rates and foreign currencies. Commodities now make up only about 2% of the CME's trading and around 18% of the CBOT's.

Though futures are little understood outside professional circles, a wide array of investors trade them, including hedge funds, pension funds, some individuals and even mutual funds that manage money for millions of people. In recent years, hedge funds and investment banks' own trading desks have used new

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**CONFERENCE CALL**

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[See a transcript](#)¹⁶ of CBOT's conference call on the planned merger, provided by Thomson StreetEvents (www.streetevents.com¹⁷). [Adobe Acrobat required](#)¹⁸.



technology and trading methods to fire in rapid trades to exchanges across the world, leading to a surge in trading volumes. Some exchanges, including the CME, have responded by catering directly to hedge funds, a sign of the growing power of some exchanges versus Wall Street firms in serving sophisticated investors.

The business of the Chicago exchanges thus is exploding, especially as they ramp up electronic trading. Doing so has enabled them to compete with European rivals that long ago moved away from the older model of a big floor on which traders jostle and shout. Last year almost 10 billion derivatives contracts, including futures, were bought or sold on the world's exchanges -- in a business that barely existed 20 years ago. Trading has grown by an average of almost 18% a year between 2002 and 2005, according to the World Federation of Exchanges.

FULL TEXT

Read the full text² of the CBOT's announcement of the deal.

WALL STREET JOURNAL VIDEO



WSJ's Aaron Lucchetti discusses³ how the Chicago Mercantile Exchange's plan to buy CBOT Holdings will likely impact investors.

⁴ Plus, CME Chairman Terrence A. Duffy and CBOT Chairman Charles P.

Carey discuss⁵ the deal, commenting on whether the merger is a "game changer" and how this affects the derivatives landscape.



The Chicago deal illustrates the increasingly rapid pace at which financial exchanges world-wide are consolidating to lift profits by cutting costs. Exchanges have morphed from member-owned clubs into profit-hungry publicly traded companies. This gives them an incentive to make acquisitions and also a currency, their stock, with which to do so.

Distinct Styles

The Chicago exchanges' styles are distinct even though they're just a few blocks apart. The CBOT has long operated in a 45-story Art Deco building topped by a statue of Ceres, the Roman goddess of grain. The CME occupies modern sand-colored towers stacked above its trading floor -- a hectic scene of arm-waving, boisterous

traders. The CME's largest contracts are Eurodollars. At the CBOT, grain remains important but has been eclipsed by Treasury-bond futures.

Both exchanges also trade options, which convey the right, but not the obligation, to buy or sell an asset later at a set price.

The two Chicago markets have a combined market value of \$26 billion, and the underlying value of contracts they trade daily is a massive \$4.2 trillion. Now, "it's going to be one big animal," said Steve Rodosky, head of U.S. government-bond trading at Pacific Investment Management Co., or Pimco, a large mutual-fund management company. "It will be a massive part of what the markets rely on every day and the only exchange to use for fixed-income derivatives."

The exchanges had talked occasionally about aligning for decades, but were deterred by rivalries between their floor traders, who owned the markets before they became public companies. This time, serious talks began before the CBOT went public in the fall of 2005. The talks revived about a month ago when CME executives contacted the CBOT, said people familiar with the matter. A flurry of meetings followed, including a dinner between the CME Chairman Terry Duffy and his CBOT counterpart, Charles Carey, at Gene & Georgetti, a famous Chicago steakhouse. About a week ago, the exchanges' executives shook hands on a deal.

The Chicago markets sealed their agreement as the New York Stock Exchange and Nasdaq Stock Market continue separate bitter fights to close their own deals -- international transactions they hope will push them into Europe and take advantage of robust stock trading overseas.

NYSE Group Inc. announced a merger deal in June with Euronext NV, which trades both stocks and derivatives. But the Big Board is in a fierce battle to close the deal as Germany's Deutsche Börse pursues its own proposal to merge with Euronext in an all-European combo.

Chicago exchange officials pointed to the consolidation overseas as a catalyst for their own deal. "If you look

at the discussions of consolidation, this is the best alternative for us," said Mr. Carey, a third-generation grain trader whose grandfather and uncle preceded him as chairman. All of them once worked the floors.

The proposed combination represents another triumph for electronic trading over pit trading. The Chicago Board of Trade started so-called open-outcry trading in 1848, and three years later traded its first corn-futures contract, for delivery of 3,000 bushels.

The Merc's value has surged, driven by the growth of its electronic trading system, called Globex. By 2001 the CME had passed the CBOT to become the largest U.S. futures exchange by number of contracts traded. The CBOT delayed embracing of electronic trading and then relied on an outside technology vendor to develop a system that was partially owned by a European competitor.

As part of the deal, the CME will close its trading floor and move the remaining trading in its pits to the CBOT, probably in late 2008. That will cut the number of major exchange trading floors in the U.S. to two: the CBOT's and the New York Stock Exchange's. The NYSE's, too, is endangered, owing to increased electronic trading there. Most exchanges in Europe and Asia rely fully on computers to match investors' orders to buy or sell.

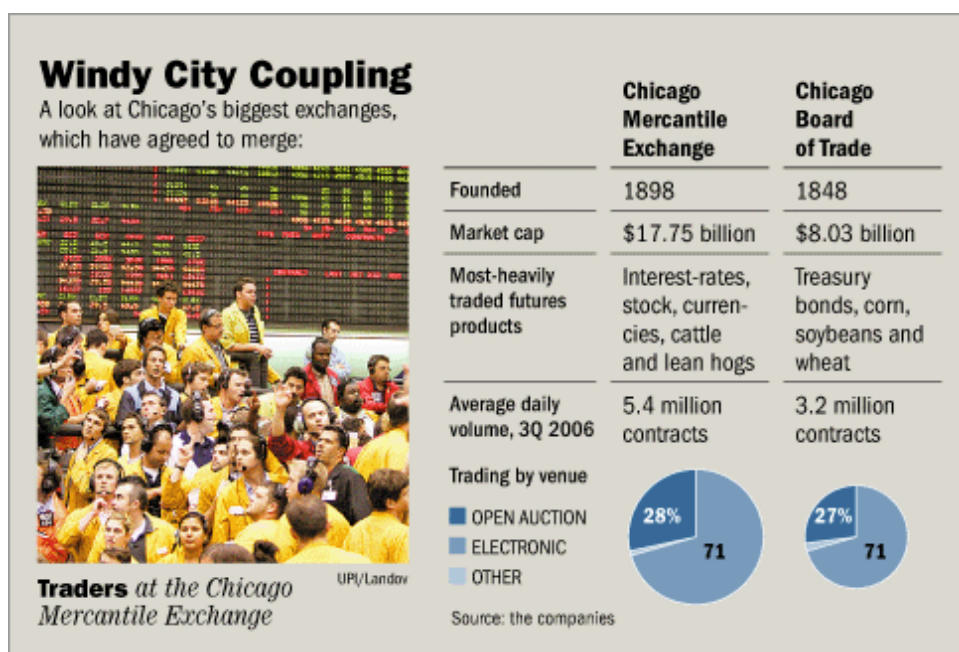
The CBOT's Mr. Carey said the deal wouldn't have happened without the Board of Trade's 2005 initial public offering. Before the offering, the CME offered to buy the CBOT for the equivalent of less than \$60 a share, according to people familiar with the matter. But the CBOT elected to go public first, and investors drove its shares up steeply from the start. It closed yesterday at \$151.99 a share, up \$17.48, or 13%, on the day. CME shares -- which are up tenfold from their December 2002 debut -- rose \$13.25, or 2.63%, to \$516.50.

The CME's Mr. Duffy is to become chairman of the combined firm, and CME Chief Executive Craig Donohue is slated to be CEO. Mr. Carey of the CBOT will be vice chairman. The deal effectively pushes aside the CBOT's chief executive, Bernard Dan, who will serve as special adviser for a year after the deal closes in mid-2007. The new company will have a large and potentially unwieldy board of 29 members, including 20 named by the CME.

The partners will save some \$125 million annually on a pretax basis starting 12 months after the deal closes, according to Mr. Donohue. The savings will come from losing one trading floor, combining the technology platforms of the two companies and much of their staff.

The savings could be used to reduce fees for customers, though that might be small comfort to some investors: Both the CBOT and the CME have raised fees in recent years -- empowered by regulations that give them exclusive trading rights to their contracts. Stock exchanges, by contrast, face much more competition because shares can trade on different exchanges.

These exclusive rights, along with the Chicago exchanges' sheer size, will provide a formidable bulwark against the NYSE and other markets that are trying to get into the futures business. Successful futures



contracts are lucrative for exchanges. This is especially so for the CME, because in addition to matching trades, it "clears" trades -- that is, guarantees that both sides of every trade get what they bargained for, either money or a viable contract. For several years, the CME has handled clearing for the CBOT.

Both exchanges have come a long way in recent years. They were put on the defensive at the time of the 1987 stock-market crash, as many argued that computerized futures trading exacerbated the losses, enabling stock declines to feed on themselves. Then a few years later, a Federal Bureau of Investigation sting operation exposed fraud on both Chicago trading floors.

As the stock market roared in the 1990s, giving the NYSE and Nasdaq record trading volumes, the Chicago exchanges struggled to compete with growing derivatives trading done off exchange, or over the counter. Big banks privately negotiated their own contracts and didn't need the financial guarantee provided by an exchange clearing house.

Those trends reversed in this decade, giving far more power to the exchanges that trade derivatives. In the early 2000s, stock trading faced a bear market and U.S. recession. But the Chicago exchanges' business proved resilient, as a tide of hedge funds continued placing bets in markets that were doing well -- bonds, foreign currencies and commodities.

The Chicago exchanges got another boost after the collapse of energy giant Enron Corp. in the early 2000s underscored the danger of private deals that would prove worthless if a company defaulted on its obligations.

By 2002, the Chicago Merc's business had improved to the point where it sold its shares to the public. The stock soon soared. By 2005, the CME was worth well more than the NYSE, long the world's marquee exchange.

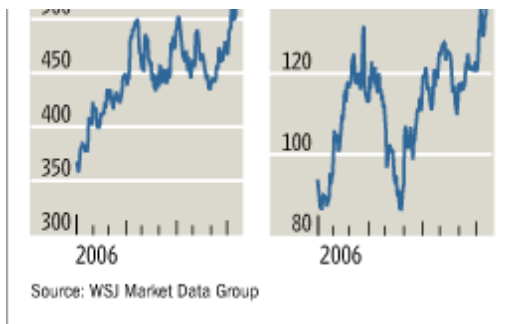
The NYSE copied the CME's strategy, announcing a public offering and following this year with its deal to buy Euronext -- thus getting into futures trading through that exchange's Euronext.liffe platform. The NYSE wants to use Euronext.liffe to grow into the futures business in the U.S. It doesn't intend to compete on products the Chicago exchanges already dominate. Instead, the NYSE will compete in new products that allow investors to bet on corporate credit risk, weather or economic indicators such as inflation.

The Chicago merger means fewer competitors in the futures industry, raising questions over whether the previously scrappy rivals will continue to innovate as effectively. That may be small comfort for the NYSE's designs on the futures business, because the Big Board now faces a much stronger competitor. Its market value would be larger than a combined NYSE-Euronext by about \$3 billion.

Battle for Dominance

The Chicago exchanges have battled for dominance in the U.S. futures industry for decades -- each lobbying for an upper hand in regulations, competing for customers and vying to create and launch the next new blockbuster product. The rivalry thawed a few years ago, when the German-Swiss futures market Eurex made a run at the CBOT's Treasuries-bond futures contracts and Euronext.liffe took on the CME Eurodollar contract. The moves prompted the Chicago exchanges to cut fees and embrace electronics to keep their edge. The CBOT also agreed to have its contracts cleared by the Chicago Merc to save costs.

Since then, the per-trade prices that exchanges charge have crept back up. The result could be some antitrust concern. There also may be regulatory concerns about the combined company's ability to handle so much business on one technology platform. The deal faces regulatory reviews by the Commodity Futures Trading Commission, the Securities and Exchange Commission and Justice Department antitrust lawyers. Current and former federal officials



yesterday said it isn't likely to be derailed.

"The Justice Department is going to want to look over any overlap in products and services, and whether the deal will avert potential competition, especially in electronic-trading platforms," said Steven Sunshine, a former antitrust enforcer now with Cadwalader Wickersham & Taft. "I don't see any major hang-ups" given strong global competition. A U.S. official agreed, because the two exchanges specialize in different types of futures and don't overlap.

Exchange officials said there will still be plenty of competition -- the large volume of derivative trades done privately through commercial and investment banks. Mr. Donohue said, "We're not expecting any significant regulatory obstacles. We're in an increasingly competitive environment. The market is globalizing. The OTC market is much larger." CME officials maintain that greater efficiencies and cost-cutting would benefit customers and that its trading systems can handle the added stresses of the merger.

The combined exchange will tie together products on one platform that make sense to trade together -- the CME interest-rate futures with the CBOT's bonds, for example, and the CME's livestock contracts with CBOT's corn, wheat and soybean contracts. The exchanges also compete with New York commodity exchanges. The CBOT launched electronic metals trading in recent years, and the CME provided technology for electronic trading of the New York Mercantile Exchange's booming energy futures contracts.

The deal calls for a swap of each CBOT Class A share for 0.3006 share of CME Class A common. CBOT shareholders can elect to receive cash, but the cash portion of payment for CBOT will be limited to \$3 billion. The CME could issue up to 15.9 million new shares as part of the deal. Of the up to \$3 billion in cash it could spend, it would raise about \$2 billion in new debt.

The Chicago Merc will own from 69% to about 80% of the combined company -- to be called CME Group Inc. -- depending on CBOT shareholders' decision on whether to accept cash or stock.

The historic deal comes as other U.S. exchanges have encountered some trouble completing their own deals. Nasdaq has built a 25.3% stake in London Stock Exchange PLC but is still being rebuffed by London, which rejected Nasdaq in an earlier approach in March. In all, LSE has had four approaches from potential buyers in two years.

And Deutsche Börse, in trying to block the NYSE from buying Euronext, has played the political card, lobbying European politicians and regulators to back a Europe-wide exchange group. The NYSE deal will be put before Euronext shareholders in December, but it is far from certain they will approve. Euronext operates stock exchanges in Paris, Amsterdam, Brussels and Lisbon as well as the Euronext.liffe derivatives exchange in London. Deutsche Börse operates the Frankfurt Stock Exchange and the Eurex derivatives exchange and trades products similar to those the CME and CBOT trade.

The CME looked at doing a deal in Europe, holding preliminary talks with Euronext and Deutsche Börse, but got nowhere, say people familiar with the matter.

Analysts said that the CME and CBOT merger won't immediately present a threat to Europe's derivatives trading platforms because it's hard for even large exchanges to take away business from an efficient electronic exchange in its home market.

In fact, the CME and CBOT tie-up could act as a stimulant to Europe's own lethargic consolidation race. It also could appease antitrust concerns in Europe about a possible combination of Deutsche Börse and Euronext, both big derivatives players. "The emergence of an even larger global competitor will be taken into account" when European antitrust regulators review deals that in the past concerned them, said Marc Reysen,

a Brussels-based lawyer.

Asia has been largely absent from the global consolidation so far. Yesterday at the World Federation of Exchanges annual gathering in São Paulo, Brazil, exchanges focused on alliances in fast-growing emerging markets, not full-blown mergers. Euronext announced a plan to cooperate with Taiwan Stock Exchange Corp. And a host of Western exchanges, including the London Stock Exchange, are angling to sign agreements with the Bombay Stock Exchange that may include an investment.

The NYSE and Euronext have expressed interest in Asian exchanges once they complete their own deal. Some analysts said that after the Chicago exchanges finish their merger, the CME Group will be among the best positioned to expand internationally.

Lehman Brothers Holdings and William Blair advised the CME, which also had legal advice from Skadden, Arps, Slate, Meagher & Flom. J.P. Morgan Chase and attorneys from Mayer, Brown, Rowe & Maw LLP advised the CBOT. Lazard Ltd. and Latham & Watkins advised a CBOT board panel on the deal's merits.

--John Wilke contributed to this article.

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