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EXCHANGING VOWS

CBOT says 'I do' to $8 billion merger offer from Merc

BY DAVID ROEDER
Business Reporter

The Chicago Mercantile Exchange and the Chicago Board of Trade, battling brothers from the 19th century who define their home city's role as a financial capital, pledged Tuesday to leave behind useless old grudges and combine to pursue growth and innovation in futures trading.

The Merc would buy out Board of Trade shareholders for about $8 billion, up to $3 billion of which could come as cash. It's a relatively straightforward deal decades in the gestation, but never born as a long as the exchanges were separated by cultures, market strategies and member politics.

All that changed in the last decade as a greater global appetite for futures trading brought more competition, and electronic markets began to silence the made-in-Chicago system of open outcry to buy and sell in a trading pit. The Merc and the Board of Trade paved the way for the deal by reorganizing themselves as public companies, putting stockholders ahead of their former member-owners who sometimes fought to keep things as they were.

If the deal is completed next year, the exchanges will operate under a new holding company, CME Group Inc. The Merc would relocate its trading floors from 20 S. Wacker to the Board of Trade's base at 141 W. Jackson. And the electronic version of the Board of Trade's contracts would move onto the Merc's system, called Globex, sometime after the CBOT's current deal with a technology provider lapses in November 2008.

Still to be settled are issues such as staff layoffs, and whether the historic Board of Trade name will survive in some fashion as the new company markets its trading opportunities to the world. Merc shareholders, rich on a stock that has risen 1,375 percent since it started trading in December 2002, clearly will be in charge, owning at least 69 percent of the new company.

But the CBOT did not come cheap

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WHAT THEY SAID

Comments on the Chicago Mercantile Exchange's proposed acquisition of the Chicago Board of Trade:

"It represents a goal that some of us harbored for the past decades, logical and compelling – one that required time. Time for our ideas to be embraced the world over. Time for our institutions to mature and become public."
Leo Melamed
Chairman emeritus, Chicago Mercantile Exchange

"It was more difficult to overcome the entrenched stickiness to open outcry at the Board of Trade. CME had no historical legacy like we had. We had this tremendous legacy, this great adherence to open outcry that took us a long time to overcome."
Patrick Arbor
Former chairman, Chicago Board of Trade

"This merger will be good for the Chicago economy because it will secure our city's position as the world leader in global financial exchanges. I'm pleased that Chicago will remain at the forefront of this growth industry."
Richard M. Daley,
Mayor of Chicago

"You haven't seen anything yet on what we'll be able to innovate on coming together."
Jack Sandner
Retired chairman, Chicago Mercantile Exchange

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Based on the market's close Tuesday, the deal values the CBOT at $155.26 a share. The exchange went public one year ago as of Thursday at $54 a share.

At the time, the Sun-Times reported, the Merc tried to preempt the Board of Trade's initial public offering by offering CBOT members about $55 a share. The Board of Trade turned up its nose, preferring to take its chances in the public markets.

The gamble paid off hugely for members who converted their seats into shares and for the executives who led the charge. But the issue of price was played down Tuesday as leaders of both exchanges extolled the cost savings and market strength the deal will create.

"Suffice to say there are pretty good traders on both sides of the table," said Merc Chief Executive Craig Donohue, slated to be CEO of the new company.

Merc Chairman Terrence Duffy said that together the exchanges will be in a "stronger position to compete, grow and pursue new market opportunities." Advantages to market users, he said, will be lower overhead that should hold down trading fees, plus the convenience of bringing business on both exchanges onto a single electronic system.

Also de-emphasized was possible job losses among the exchange's combined staffs of 2,200. The deal has its greatest effect, though, on trading firms that work at the exchanges. Estimates are that those jobs number about 50,000.

CBOT Chairman Charles Carey, who will be vice chairman of the new enterprise, said, "By making ourselves more competitive on a global basis, as we witness consolidations taking place, this is going to go a long way to ensuring that those jobs stay here in Chicago supporting this one great exchange."

There is little overlap in the exchanges' core markets. The Merc relies on futures tied to stock indexes such as the Nasdaq and Standard & Poor's, the Eurodollar interest rate contract, foreign currencies and livestock and dairy markets. The CBOT lists contracts tied to Treasury rates, crop prices, the Dow Jones industrial average and, increasingly, precious metals.

Both report trading volumes are at record levels. Together, they average about 9 million contracts per day.

What happens to the Merc floors on Wacker is still to be decided. The floors themselves are owned by a Merc-affiliated charitable trust. They are between two office towers owned by Sam Zell's Equity Office Properties Trust. The Merc rents space there, but it has agreed to move back-office operations to 550 W. Washington starting in 2007.

Executives said the sale will bring $125 million in annual cost savings, a figure some analysts said was low. Morningstar Inc. analyst Patrick O'Shaughnessy praised the deal and said its value should rise as growth expectations drive up the value of Merc shares.

Duffy said that just as important as the business rationale for the deal is the working relationship between the exchanges. In 2003, the CBOT brought the Merc its business in clearing, or financially insuring, its daily volume. The step lowered costs for futures traders, and Duffy said the full buyout is the "logical next step" from that move.

"We know the futures business better than anyone else, but we also know the people we are merging with," he said.

Indeed, one catalyst for the deal is Duffy's friendship with Carey. They know each other going back to 1983, when Carey, in a break from the Board of Trade, dealt hog futures at the Merc.

Carey is a veteran corn trader and represents the third generation of his family active at the exchange. He said the CBOT's board studied alternatives and concluded that selling to the Merc "was the very best option for the CBOT and our customers."

His grandfather was a Board of Trade chairman in the 1930s, and his uncle had a stint in the same office in the 1960s.

Duffy and Carey both come from the agriculture markets, known as the part at each exchange that's the most resistant to new ideas. It's an unlikely background for executives who directed such a radical transformation, but it probably helped them sell reluctant traders on the possibilities of the new age.

And soaring stock prices haven't hurt their stature.

The deal was announced before the market opened Tuesday, and the news sent shares of the Merc's parent, Chicago Mercantile Exchange Holdings Inc., up $13.25, or 2.6 percent, to a record close of $516.50. The CBOT parent, CBOT Holdings Inc., saw its shares gain $17.48, or 13 percent, to $151.99, also a record close.

"It's about time" they got together, said Robert Hamada, professor emeritus of finance at the University of Chicago and a former board member of the CBOT. The Merc led the way with its 2002 IPO, but the Board of Trade was hobbled on that path by a lawsuit over the apportionment of ownership interests from different membership classes, Hamada said.

"The CBOT had a much more complicated structure. That's one reason it's taken such a long time," Hamada said. He said traders will benefit by seeing a broader range of products on a single computer system, opening up the potential for arbitrage strategies, or trading one market against another.

Sources said the sale was negotiated in earnest over the last two weeks. One person said the Merc's board approved it late Sunday and the CBOT board followed suit during the overnight hours before Tuesday morning, although haggling on some terms continued until about 6 a.m.

Longtime exchange stalwarts recalled past efforts to achieve a union, all of which failed because the operations were fully controlled by members who didn't want to cede power to somebody else, C.C. Odom II, a CBOT board member involved in the talks, said several discussions took place in the 1970s and 1980s.

For decades, the exchanges were innately suspicious of one another even as they jointly put Chicago on the futures map. Their rivalry is personified by an annual charity boxing event that features strapping partisans from both sides punching the daylights out of each other.

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HOW THE DEAL WORKS

Value: About $8 billion

Terms: Shareholders of the Chicago Board of Trade parent, CBOT Holdings Inc., will have the right to receive 0.3006 shares of the Chicago Mercantile Exchange's parent, Chicago Mercantile Exchange Holdings Inc. for each CBOT share they own.

- CBOT shareholders can take payout in cash, based on 10-day average closing price of CME shares when the deal is completed. Cash payout capped at $3 billion and will be prorated if payment requests exceed that limit.
- If no stockholders receive cash, CME shareholders would own 69 percent of the new company, to be called CME Group Inc.
- No impact on trading rights or clearing privileges at either exchange.

Expected closing: Mid-2007

Operational changes: Projected cost savings of $125 million a year, starting in the second year after the sale.

- CME will move trading floor into the Board of Trade facilities at 141 W. Jackson.
- Electronic marketplace for Board of Trade contracts eventually will be CME Globex network, and exchanges will merge technology functions.
- Some layoffs likely in combined work force (current payroll is 1,406 at the Merc and 768 at the Board of Trade), but executives emphasize the deal is about growth.

Terrence Duffy

Charles Carey

Managers in: CME Chairman Terrence Duffy will be chairman of new company, Board of Trade Chairman Charles Carey will be vice chairman.

- Craig Donohue, chief executive of CME, will be new company's chief executive.
- New board will have 20 members from CME, nine from Board of Trade.

Craig Donohue

Manager out: Bernard Dan, Board of Trade president, will serve as special adviser for one year after deal closes and exit.

Bernard Dan

What must happen: Shareholder approval from both companies and separately from Board of Trade members.

- Approval from the Commodity Futures Trading Commission, which regulates futures trading, the Securities and Exchange Commission and the U.S. Justice Department, which is expected to conduct an anti-trust review.

Implementation: The exchanges have established a transaction committee including the top managers, plus, for the CME, President Phupinder Gill; Chairman Emeritus Leo Melamed; retired Chairman Jack Sandner; and for the Board of Trade, members C.C. Odom II, Joseph Niciforo and Christopher Stewart.

Other helpers: For the CME, Lehman Brothers, William Blair & Co. LLC and Skadden, Arps, Slate, Meagher & Flom LLP. For the Board of Trade, J.P. Morgan, Mayer, Brown, Rowe & Maw LLP, Lazard Freres & Co. LLC and Latham & Watkins LLP.

—David Roeder