TRADING TALK

Market Structure Analysis & Trading Strategy

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You Can't Always Get What You Want, But if You Try Sometimes Well You Just Might Find You Get What You Need…Thoughts on Nasdaq/OMX Deal and Global Exchange Consolidation More Generally

The good

In the global exchange consolidation beauty contest, OMX is not the beauty that most people associate with the Nordic countries' reputation for beautiful women. Don't get us wrong, it is a good asset—its tentacles are in many of the world's exchanges through its technology platform and it has also been a successful integrator of exchanges. These are valuable skills in a world of consolidating exchanges that Nasdaq is smart to recognize. And while all European exchanges will undoubtedly try to spin MiFID as more of an opportunity for new business in terms of providing platforms to new broker competitors and multilateral trading facilities than a threat to their primacy (as NYSE Euronext indeed did at its analyst day on June 6th), OMX has the best chance of delivering on that, although Atos Euronext can't be ruled out as a technology arms supplier either. It has already introduced the MiFID Service Menu, which will include new services for systematic internalizers and new transaction reporting services, among other things. In addition, its clearing systems could prove interesting if certain vertically integrated trading/clearing markets like that of US futures and much of European equities trading open up at some point.

The bad

That said, OMX is the fourth best asset in Europe, not even globally (the Miss Europe contest, not Miss World, or for those of you in the UK, an also-ran at the Epsom Derby). While much was made of the derivatives presence OMX would give Nasdaq in Europe, in terms of options volume the OMX is number three in Europe, but dwarfed by its larger competitors there, with Eurex about five times as large and Euronext.LIFFE almost three times as large. And it is only eighth globally, actually significantly smaller than some that might surprise you like the Amex and Philadelphia in the US and Bovespa in Brazil. In fact, it is only a hair larger in options volume than the Buenos Aires exchange and the only one of the world's top ten option exchanges actually experiencing a major decline in options volumes in the January to April 2007 period relative to the same period in 2006. With respect to equities trading, again OMX is no giant, coming in at the fifth most active in Europe in terms of the number of trades and sixth in terms of the value of trading in 2006 representing about 2.1% of the value of cash equity trading globally in the first quarter of 2007 (according to World Federation of Exchanges data), which is not only less than half the size of Deutsche Borse and less than one-fifth the size of the LSE, but actually smaller than the Borsa Italiana and the BME of Spain (at 2.3% and 3.2% respectively). In addition, with Project Boat (the consortium set up to provide an alternative platform for trade reporting to current European exchanges and then sell the market data) heating up with MiFID approaching and five more large banks agreeing to provide it trading data last week, OMX faces another risk. OMX's revenue from market data sales as a percentage of total sales is higher than any other European exchange and that makes it more vulnerable to Project Boat than others, although undoubtedly it will try to launch new transaction reporting services in response to MiFID as well and is better positioned than most to deliver as mentioned before.

Richard Rosenblatt
rrosenblatt@rblt.com

Joe Gawronski
jgawronski@rblt.com

20 Broad Street
New York, NY
(212) 607-3100

Its biggest strength—the fact that it is a technology leader[1] and the provider of exchange technology to 60 different customers throughout the world—could also prove a great weakness in one respect and is thus a double-edged sword. While it serves to diversify its revenue base and, as many have noted, the relationships with exchange managements and knowledge of the particularities of each exchange could prove beneficial as more acquisitions are contemplated, it also poses a risk. Many of these exchanges are going to take a second look at their decision to outsource the arguable lifeblood of their organization to OMX with Nasdaq now as the owner. To use the cultural stereotypes of each home country, OMX fits the image of the Nordic countries' reputation for being non-threatening and neutral, while Nasdaq fits the brash, aggressive image of the United States. Accordingly, we believe there are potential exchange client defections in the future that will result in revenue losses. One exchange official we spoke to that in fact does use OMX's software said the acquisition is indeed a concern and they will have to re-examine their technology decision going forward. Of course, it is not a simple decision to switch platforms or build a new platform, so the defections will not likely be widespread, but may occur in the most sensitive situations or in the event a major competitor to Nasdaq such as the NYSE were to acquire or take an equity stake or form a deep relationship with an OMX client such as the Hong Kong Stock Exchange or Singapore Exchange, e.g., last week's Tokyo Stock Exchange (TSE) purchase of 4.99% of the Singapore Exchange could possibly complicate things in the future as the NYSE and TSE tighten their own relationship. Interestingly, the LSE itself recently decided to bring its 150-member IT staff back in-house after years of outsourcing to Accenture. With the proliferation of exchanges and other trading venues and the black eyes numerous exchanges such as the TSE have taken for technology hiccups, it would not be surprising for exchanges to look more carefully at this.

The necessary

Basically, as you can tell, we're somewhat lukewarm on the acquisition—it's a decent deal for Nasdaq and one that it probably needs to fulfill its ambitions, but not a home run. Thus, the reference to the Rolling Stones lyrics in the title. Having sat back and watched the NYSE acquire Euronext and thus far having failed to shakedown the LSE, Nasdaq had to eat an international meal or face being eaten. Some type of deal was absolutely necessary to keep Greifeld in the game as a survivor, which he clearly wants to be, and potentially one of the leaders of the 3 or 4 large global, multi-product exchanges conventional wisdom is saying will survive. With a combined market cap of about $7 billion, it adds enough heft to be in the game as a potential survivor, but barely. It seems like an incremental step and one perhaps intended to give Nasdaq more leverage on an LSE deal.

As a side note, interestingly, while the NYSE has excelled in the global consolidation game with the Arca and Euronext deals and struggled in the domestic market share game, Nasdaq has been the exact reverse. Nasdaq has impressively picked up very meaningful market share in NYSE-listed trading in the past year or so and has successfully sewn up a dominance in trading Nasdaq stocks with successful integrations of Brut and INET/Island after Supermontage was at first a failure and even taken share from NYSE Arca in Nasdaq-listed trading of late to boot. However, on a scale of 1 to 10 rating the dexterity of global consolidators (with Deutsche Borse being near the bottom and the ICE near the top[2]), Nasdaq is much nearer to the bottom at this point considering this mediocre deal and its failure to win over the LSE thus far.

[1] In addition to its exchange software services, OMX owns a chunk of Orc Software, a provider of trading solutions to the buy-side and sell-side, just like Euronext owns a large chunk of GL Trade. The model of exchanges owning front-end systems seems to be more prevalent in Europe than in the US, where the brokerage firms and independent software providers have dominated the space.

[2] While Deutsche Borse's Eurex unit is acquiring a very nice asset in the ISE, it is paying through the nose for it and, more importantly, shareholder dissatisfaction is rearing its head again at Deutsche Borse, reminding us of the not-too-distant past when its CEO was put on the chopping block when shareholders disagreed with his LSE strategy. On the other hand, no matter how the battle for the CBOT ultimately plays out, ICE has been a clever consolidator and very savvy internationally thus far. Not only did it lock up the NYBOT last year, recently buy Chemconnect (the leading electronic marketplace for the US natural gas liquids and chemicals markets) strengthening its lead in the OTC energy markets, and exploit the differences in the UK and US rules in the futures market to its advantage, but at minimum it will cause the CME to pay a much higher price than it would otherwise for the CBOT and still has an outside chance of walking a way with the asset with its bold move, especially with the valuation gap between the two deals still hovering at about $800 million. ICE has conducted the bid in a very intelligent way, outmaneuvering the CME thus far at each step, e.g., by addressing the CBOE exercise rights issue—a sore point with CBOT members--and sweetening the terms of its proposal and addressing issues members had raised the day of the DoJ's approval of the CME/CBOT deal, stealing the public relations victory out from under the CME. Granted, the strategy could backfire as the ICE could find itself in the NYSE's crosshairs if it loses the battle, but informed by Joe's past life in the takeover group at Sullivan & Cromwell, we have to say it has been well-played, especially in contrast to Nasdaq's hostile bid for LSE, which has not been.

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Next steps--Looking east and to options

This acquisition will not satisfy Greifeld's appetite and there is more to come and likely prior to him even making another run at London since his ability to do that is some months away under UK takeover law. We'll share a few more thoughts on the LSE later, but for now two things are worth noting. There is a good chance Nasdaq/OMX will try to look east for growth. Despite the recent success the US has had with China listings (winning 10 IPOs this year already compared with 7 in all of 2006--but the NYSE winning 6 of the 10), south and east Asia would still be the most desirous because of the tremendous growth there with local market listings still exploding.[3] The Chinese and Indian markets still have restrictive foreign ownership provisions that would prevent deals (outside of small ownership stakes in India) though and, even with the recent announcement of the underwriters for its IPO, Tokyo is still crawling along towards a December 2008 IPO date at the earliest and almost certainly more likely to work with the NYSE (or the LSE with whom they also signed an alliance) than Nasdaq. Clearly, Nasdaq would like to go beyond a vague Memorandum of Understanding with the Shanghai Stock Exchange in Asia (that the NYSE and Euronext also have with Shanghai no less), but right now that may be all that is possible right now in those markets. Eastern Europe may be the logical compromise and as far east as they can go at this time as that market is ripe for consolidation and OMX has already been making waves there.

With the OMX market share in options more anemic than the press might lead one to believe and Greifeld admitting publicly that the new options market Nasdaq is launching by year-end is expected only to garner only a few percentage points of market share, Nasdaq will likely decide to do something else in the derivatives area. While a futures presence might be even more attractive from a margin and competitive positioning standpoint, there is nothing small enough in that arena for Nasdaq to sink its teeth into right now at its current size. Philadelphia is bite-sized and with fifteen percentage points of market share would start to create a scale business on the options front (not to mention add a nascent futures business that Philadelphia's wily CEO Sandy Frucher is trying to create) so it's not surprising that there has been speculation about that. With the ISE recently scooped up by Deutsche-Borse/Eurex, the old Pacific Stock Exchange owned by NYSE Arca, and the Boston too small to add the scale Greifeld wants, there are only a couple of other assets available on the US options front, and they are admittedly dark horse candidates. A second marriage to the Amex can't be entirely ruled out because of its ten percentage points or so options market share, small size and the small company and ETF listings business that actually fits nicely into Nasdaq's equity business. However, with the Amex being shopped for as long as it has and the first experience with the NASD not working out so well, it still would be a surprise. Perhaps even more shocking would be a Nasdaq attempt to tie-up with the CBOE. While this asset might more naturally be seen as fitting with the Chicago futures giants or even the NYSE because of a shared history of floor trading, we don't see either of those as likely in the cards in the near-term for the CBOE. The CME and CBOT are pre-occupied with their pending nuptials, while the NYSE seems like it has its heart set on expanding in the US futures business (rather than options, its more commoditized derivatives business cousin, where it seems content to grown organically through NYSE Arca for now, especially if the penny pilot expands where Arca's pricing model has done well) and the valuation demanded would likely be too rich for the NYSE in any case. In light of prior negotiations with the ISE, the NYSE was surely given an opportunity to do a deal with the ISE at the $2.8 billion price Deutsche Borse/Eurex paid and must have passed. Since seatholders would presumably demand a premium to the $2.3 billion[4] implied current CBOE valuation at which they can sell their seats, one has to factor in the hundreds of millions the CBOE might have to pay CBOT members who are also members of the CBOE to extinguish any claim they would have on the equity and there is little to no private company discount considering the CBOE and ISE are neck and neck for top options volume players. With electronic trading now combined with open outcry at the CBOE, the possibility of taking a private company public a la Arca/NYSE in reverse, and a real aggressiveness on the leverage front, a Nasdaq play for the CBOE could be possible. Whether Nasdaq paper would be attractive to the CBOE is a different story.

[3] In fact weekend reports suggest that China Construction Bank and China Cosco Holdings are each planning billion dollar plus offerings in Shanghai, Guangzhou Automobile and China Metallurgical are also planning billion dollar plus offerings in Hong Kong, and Shanxi Province Coal Transportation is close to appointing advisers to arrange a $1 billion-plus simultaneous listing in Hong Kong and Shanghai.

[4] This back of the envelope calculation is based on last sale seat prices of about $2.5 million and the 931 seats mentioned in Amendment No. 1 to the CBOE's S-4 dated May 11, 2007 detailing the demutualization transaction.

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LSE implications

Nasdaq's bulking up, particularly in Europe with a partner who itself has gone after the LSE before, certainly adds to the pressure on London to do something if it wants to be a survivor or even determine its own destiny and pick its desired partner in the international exchange consolidation game. We have long maintained that Nasdaq's hostile approach would have a great deal of difficulty in succeeding when the LSE was beating numbers[5] and continue to believe that the LSE has more freedom of action than the so-called Nasdaq blocking stake implies. See, for instance, "Nasdaq Makes Strong Move to the Hoop for LSE, Will the NYSE Just Clear the Lane and Watch?" http://www.rblt.com/documents/NasdaqLSE4-12-2006.pdf. That said, time is running out and the odds of a deal with Nasdaq have increased. The NYSE's recent comments on the cash equities markets in Europe all but ruled out a bid for the LSE and thus the NYSE should no longer be considered a viable white knight candidate, while Deutsche Borse, having failed once before and already at odds with certain shareholders over premium deals, would be an unlikely partner as well. There are, however, a number of options for the LSE.

One option is to team up with either Spain's BME or the Borsa Italiana[6] to bulk up its equities business, but each of those might prefer to remain independent at this stage rather than be junior partners and perhaps even wait out for renewed interest from NYSE Euronext or Deutsche Borse down the road. That said, this could be the time to strike for the LSE with NYSE Euronext not focused on growing its European cash equities business through acquisition and Deutsche Borse muddled in shareholder woes with the ISE deal. Like Nasdaq and most of the other exchanges of the world, the LSE could try to look east for opportunity since that is where the growth is.[7] For instance, the tremendous listings success the LSE has had with Russian companies might point towards solidifying these gains in eastern Europe and Russia. However, there are complicated ownership issues with the MICEX and RTS and it is likely too rough and tumble of a market at this point for the LSE even if the Russian government were open to allowing such a transaction (see, for instance, the TNK-BP issues that might cause London pause, never mind the recent strained relations between Putin and Blair), while OMX is perhaps better positioned for growth in eastern Europe with its current operation of the three Baltic country markets. Moving just a bit further east, the Middle East to be exact, the possibility of teaming up with the Dubai International Financial Centre (DIFC) and Dubai International Financial Exchange (DIFX) in some way cannot be ruled out. Perhaps there is more smoke than fire there generally at this point with the DIFC and DIFX, but with the massive oil wealth (enhanced by a recent $1.25 billion flotation of a sukuk, i.e., Islamic bond), a largely shared legal code with the UK, and great ambitions, a tie-up through cross-shareholdings, collaboration on trading systems, joint ventures for new markets or joint bid on an asset could be possible, e.g., imagine even a joint play for OMX by DIFX and the LSE with Per Larsson, former CEO of OMX, not to mention a bidder for the LSE back in 2000, now heading DIFX. Of course, the LSE might like to look even further east for the massive growth opportunities in trading volumes and listings, especially with a number of the Commonwealth countries or former colonies, like India and Hong Kong. Those moves though look limited to vague alliances and small investments right now and besides NYSE Euronext is already in the pole position with its 5% stake in India's NSE and what appears to be a tight relationship with the Tokyo Stock Exchange (despite LSE's own alliance) and Deutsche Borse on its heels with a 5% stake in the Bombay Stock Exchange.

There are of course other possibilities with Commonwealth countries and/or others that share even closer cultural history and language. For instance, if Sarbanes Oxley weren't too off-putting, the Amex's complementary nature (i.e., with respect to small and emerging company listings) to the LSE's junior AIM market could make an appealing small acquisition and add a presence not only in the US, but in derivatives, a gaping hole for the LSE. Similarly, the Toronto Stock Exchange (TSX) has been a bit of laggard in terms of stock performance and is about the right size.

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[5] The exchange space, while arguably priced to perfection, continues to have the wind at its back in two important respects. First, the prospect of consolidation (read takeover premiums) and the reality of cost synergies from that consolidation. While the LSE has not done any deals, many other firms, like the NYSE, have one deal or more that are still allowing them to beat numbers easily. Second, trading volumes have continued to be robust on most of the major exchanges (even more so on ones like the NYSE that have experienced the boom in volumes that electronification inevitably brings) and capital markets activities have fuelled listings in the dominant developed world equities markets even as home country markets in the developing world like China have strengthened. The LSE continues to impress on the IPO market front, representing 53% of all European IPOs, and, when its junior AIM market is included, $62 billion of IPO capital raised overall, ahead of Hong Kong at $47 billion in 2006 and only slightly behind the combined NYSE Euronext at $68 billion in 2006.

[6] In fact, in late January of 2007, Massimo Capuano, CEO of the Borsa Italiana, said he had always regarded the LSE as "a very interesting" potential partner and that "The LSE is still involved in the Nasdaq deal. We're waiting for the end of that." In addition, in March 2005 Borsa Italiana had made similar overtures to the LSE as Deutsche Borse tried to acquire the LSE, with Capuano then calling it an "attractive partner." All that said, we don't get the impression that the Italians are in any rush to do a deal.

[7] According to World Federation of Exchanges data, the top five exchanges in terms of growth in listed market cap from 2005 to 2006 were Shanghai, Shenzen, Hong Kong, the Wiener Borse of Austria (Eastern Europe) and NSE of India.

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However, the DEX derivatives joint venture with the ISE (soon to be subsumed under the Deutsche Borse umbrella) could be a complicating factor in a deal for the TSX, so the Montreal Exchange could be an even more logical target with the derivatives exposure it brings. The Johannesburg Stock Exchange already has an IT contract with the LSE and is small enough for a bolt-on acquisition to begin to bulk up. The Australian Securities Exchange now that it includes both futures and stocks upon the merger of ASX and the Sydney Futures Exchange at the end of last year would also be attractive and again offer a way into the futures market.

Let's not forget that the LSE would seem to have a natural interest in an asset that could give it a derivatives presence. Not only did the LSE lose the battle in its own backyard for a futures presence when Euronext won the LIFFE deal back in 2001/2002, but Clara Furse, long before she became CEO of the LSE in 2001, started in the business as a commodities broker at Philips & Drew, ran the global futures and options business at UBS after it acquired Philips & Drew, was the CEO of Credit Lyonnais' commodities division and was a director and deputy chairman of LIFFE. Being one of the global survivors in the exchange business rather than a niche player in one asset class will require a presence in the futures markets. The LSE has the brand name to be a much bigger player and Clara Furse the background in the futures business, so one of the most logical moves would be to expand into the futures business. Of course, that is extremely difficult to do organically as John Thain recently admitted when detailing his interest in acquiring a US futures exchange. Unfortunately, most of the world's major futures exchanges are either a part of larger conglomerates already or have market caps far in excess of the LSE. Conveniently, however, the London Metals Exchange (LME), which is the dominant market for non-ferrous metals trading and trying to grow in plastics, steel and OTC instruments as well, is located right in the LSE's backyard. This could be a very interesting pairing at some point. Relatively new LME CEO Martin Abbot's public and private statements have consistently delineated a "go it alone" strategy and expressed a desire to stay out of the global exchange merger/alliance frenzy. In light of the fact that it is well-capitalized to undertake its current initiatives and its members at least right now think they prefer the profits they make year in and year out as part of a small club that dominates a part of the commodities market to cashing out, it certainly could be several years before they are ready to do something if at all. However, with the valuations being assigned to futures exchanges these days we could see something happen sooner. A compelling deal put on the table by the LSE or for that matter the NYSE if it turns it focus overseas again on the futures front or one of the other major futures players could change the membership's mind.[8]

A few words on the NYSE

Since the mainstream press is writing pretty extensively on the topic of the NYSE Euronext's next possible target in the global exchange consolidation game, we don't need to repeat it. However, we do think it is worth mentioning a few things. First, while bits and pieces have made it into the press in a more speculative fashion, CEO John Thain and CFO Nelson Chai's comments at the NYSE June 6th analyst day are worth summarizing factually.

When asked what the $400 million or so NYSE Euronext would soon receive from the reduction in its LCH Clearnet stake could be used for, Nelson Chai said they'd be willing to "take a swing" at a big opportunity, even using the NYSE's strong balance sheet (strongly hinting at the distinction from Nasdaq's) if related to "the end game" as they believe they can "walk and chew gum" at the same time, i.e., successfully integrate Euronext and undertake another major acquisition. Chai also downplayed the comments he had made at the Fox Pitt financial services conference about the ICE "putting itself into play" by bidding for the CBOT in a transaction that would leave it with a minority ownership in the surviving combined entity, saying that was just his personal opinion and not a reflection of any NYSE strategy.

Thain's comments were even more explicit on several fronts. Starting with where outright acquisitions are not likely, Thain noted that strategically NYSE Euronext does not need a bigger cash presence in Europe, all but ruling out an LSE bid. Thain also made clear that while Asian expansion plans continue they will primarily be achieved by

[8] We don't want to focus on the LME valuation here as we really just wanted to make the point about other options the LSE might have. However, based on the last sale of ordinary shares through the secondary trading mechanism set up at the LME, the implied valuation of the LME is extraordinarily low in comparison to the market caps of the public futures exchanges, such as the NYMEX, if it were actually running as a more commercial enterprise when you consider the LME's contract volume was almost one-third of NYMEX's in '06. Granted there should be steep private company discount because of the expressed desire to remain independent and private, but the prices at which ordinary shares have actually traded within the past month or so are far beyond such a discount for such a plum asset. If any one is interested in discussing further the LME, please feel free to call or email as we have done some work on this one and it has some hair on it, but is worth exploring.

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equity investments and not the actual management of assets, specifically mentioning that between now and 2009 when the Tokyo Stock Exchange goes public he expects a chance to acquire an equity stake and that he expects to expand his presence in India "in the not too distant future." Expanding the US derivatives business was clearly set out as his priority, calling it the "biggest hole" in his business. While at first noting that his US options market share needs to go up from 12% or so, making us think that a deal for the CBOE could be possible (perhaps again cleverly using the Arca model to take a member-owned exchange public), he added that he thought any move to pennies would help the Arca options business grow organically and quickly turned the attention to the futures business. Thain continued that while LIFFE's products will certainly get distribution in the US through the merger with Euronext, it was not enough to go head-to-head with a combined CME/CBOT and that that "has to be [achieved] by acquisition." He also specifically said in answer to a question that no discussions with the ICE-owned NYBOT had taken place regarding providing floor trading space.

The second thing worth noting is that it is worth listening to what John Thain says. Pretty much everything he has publicly said or strongly hinted at he has done. He talked about exploring ways to go public and did the Arca deal. He talked about wanting to expand internationally and in derivatives and shortly thereafter announced the Euronext deal. He talked about being interested in Japan, China and India, and sure enough soon thereafter announces a strategic alliance with Tokyo and an investment in the NSE of India, only falling short of the third goal in Asia because there are no major opportunities possible at this time in China because of various foreign ownership restrictions. In any event, it has seemed that some analysts and the press have been surprised by some of these prior actions and shouldn't have been as Thain's actions have been following his words spot-on thus far. With all the ink spent on the speculation about acquiring a futures market the past week, perhaps people are starting to believe him.

Third, and just for fun to add to the chorus of speculation, the NYMEX seems to make the most sense to us in a tie-up with the NYSE for a few reasons. CME and ICE are preoccupied with the battle over CBOT and both seem to want to be survivors in control of their destiny (despite the fact that ICE would have a minority ownership in a combined CBOT/ICE entity, CEO Jeff Sprecher would still control management and the board). NYMEX, on the other hand, seems like a willing seller based on all reports. Rather than going hostile and adding a third bid to the mix in the CBOT battle or waiting to talk to the loser of the battle (each of whom seems less inclined to sell), the NYMEX might be an easy-do if the NYSE can get comfortable with the valuation and a dilutive deal. Also, like the ICE's NYBOT, the NYMEX does have a trading floor in New York City, so there are some synergies that can be achieved in combining trading floors, especially when the NYSE has gone from five trading rooms to four already and President Duncan Niederauer has said publicly that he expects further consolidation of rooms by year-end (the only question seems to be whether the NYSE will go to three or two). One fly in the ointment is the ten-year contract that was signed just a little over a year ago between NYMEX and the CME in which the CME's Globex became the exclusive electronic trading services provider for NYMEX's energy futures and options contracts, especially as the percentage of electronic trading vs. floor trading has grown dramatically over that time and the NYSE would presumably prefer not to have to pay license fees to what will likely be its biggest rival. Perhaps the consummation of a CME/CBOT transaction will make the issue less sticky since the CBOT competes with the NYMEX in metals and there's a good chance the agreement between the NYMEX and CME would not allow for competitive offerings so the CME may be forced to compromise on the ten-year deal. In any event, while NYMEX looks to be the likeliest target to us, the main point we'd make is that something will almost certainly happen in terms of a derivatives acquisition as Thain has continually said what he means on the strategy front.

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