



Ocean Tomo Fall 2006 Live Intellectual Property Auction Gala
By Neal L. Wolkoff, Chairman and CEO of the American Stock Exchange

Good evening.

Let me first say thank you to Ocean Tomo for inviting me to speak to you tonight. I find that Ocean Tomo's initiatives in intellectual property auctions fit within my appreciation for the ability of market mechanisms to respond to all sorts of needs. I have spent the better part of my professional career at exchanges providing the necessary infrastructure and conducive environment for buyers and sellers to confidently transact. I applaud the innovative approach to bring competition and transparency—the hallmarks of all good markets—to something like IP rights. I am a Jimi Hendrix fan, which only adds to my appreciation.

Let me also mention that at the Amex we have had the pleasure of working with Jim's team on the Ocean Tomo 300 Patent Index, which is the first index designed to represent the broad spectrum of companies that have valuable corporate intellectual property. The Index is a new tool to allow investors to track the performance of companies with high quality patent portfolios. Claymore Securities has taken a license to create an ETF based on this index, which we hope to see launched in the near future, and listed on the Amex.

Anyway, as Brian said, I am Neal Wolkoff, Chairman and CEO of the American Stock Exchange. Many of you probably don't know anything about the exchange business. That's okay, since I have built a career around knowing what most others find mysterious. I do not have substantive expertise in the intellectual property business. But I do know that our industry is undergoing dramatic changes which are driving new innovations that will shape our industry in the years to come. Intellectual property rights play, and will continue to play, an important role in financial services by helping to determine who will most benefit from the dramatic changes that are coming. Indeed, in just the last few years, we have seen an impressive library of innovations coupled with IP protections, and we have seen some ideas that are dressed up as innovations trying to seek the cover of the same IP protections.

The evolving exchange landscape can serve as a model for what is happening in countless other industries, as technological advances drive increased competition at an ever-accelerating pace. So what I thought I would do tonight is talk about Amex's specific experiences with respect to intellectual property—how it is affecting us, and how we are thinking about it in our business strategy. Amex is one of three primary national exchanges, but we are both the smallest of the three, and the only one with a claim to being the leader in product innovation. Our story illustrates the varied approaches and strategies that all businesses must consider to succeed in these extremely competitive times.

First, some background. For most of its history, Amex operated in a relatively safe business environment. One of only a handful of national securities exchanges in the US, we were the home for smaller and mid-size companies, and nearly all trading in our listed companies occurred on our trading floor. In the early seventies, we added listed options to our business, and in 1993, we launched trading in SPDRs, the first exchange traded fund, or "ETF". For anyone unfamiliar with ETFs, they are pooled investment vehicles like index mutual funds, but which trade throughout the day like shares of stock on an exchange.

Like most other industries, the exchange world has changed dramatically over the years. The development of the Nasdaq stock market as a listing venue not just for risky start-ups, but also for established mid- and large-sized companies has intensified the competition for primary stock listings. The development of alternative trading systems and electronic communication networks (“ECNs”) has fomented brutal competition for market share in trading of listed securities across all markets. Through a statute, so-called Unlisted Trading Privileges, allow each listing venue as well as each ATS and ECN to trade almost all of each others’ listings. And like everywhere else in the world, the pace of change is accelerating—exchanges and ECNs are demutualizing, turning into public corporations accountable to shareholders, and merging or forming alliances at a dizzying pace, both domestically and internationally. Just last week, the Chicago Mercantile Exchange bought the Chicago Board of Trade for \$8 billion!! That truly is an astounding number. The combined entity will be the largest derivatives market in the world worth some \$25 billion.

These combinations are being driven by the relentless commoditization of the exchanges’ core transaction business. Because of the competition across marketplaces for trading in the same listings, the amount an exchange is able to charge for a transaction today is a tiny fraction of what it was just a few years ago. In response, exchanges are looking to build scale through mergers which not only can increase the number of transactions an exchange handles in its existing business, but also can add new types of instruments to trade, such as derivatives like options and futures.

In this hypercompetitive environment, exchanges have to create new strategies to survive by differentiating themselves from each other, and find new ways to protect and extract value from their innovations. As we at the Amex look to the future, we think there will be significantly greater emphasis on protection of IP rights around innovation. These efforts will fall mostly into three broad categories: technology; information; and product offerings. Each of these areas has had, and will continue to have, its own issues with respect to intellectual property rights.

Let’s start with technology. This is an area where everyone is competing to develop faster, cheaper technology to execute transactions. Often technology is designed to support a particular market structure. In our case, we have spent almost the last two years developing a new trading platform which we have named AEMI—for Auction and Electronic Market Integration—which we will rely upon to differentiate our offering from our competitors. As its name implies, this new technology and our accompanying new market structure are designed to provide a marketplace where the great bulk of transactions occur electronically and instantaneously, but in the infrequent event that there is a material break away from current equilibrium between supply and demand, a more traditional specialist-led auction market occurs until a new equilibrium point is established. At that point, the electronic trading mechanism takes over once more. We expect to begin rolling out our new trading platform on November 6, with 2 listings, and we will be fully deployed before Regulation NMS requirements take effect in February.

Rather than try to build the technology from scratch in house, our approach to develop AEMI involved partnering with an outside vendor to customize their electronic exchange platform to meet our needs. To protect our competitive position, we own our unique contributions to the end product. This approach gives us the flexibility to build on the best-in-breed core offering as the market evolves while protecting our rights in those elements of the environment that we have contributed.

Second, let’s look at information. Exchanges traditionally have made a significant portion of their revenue from selling market data—information on trades and quotes. But now exchanges are becoming more sophisticated in their approach to market data, and are selling new data-related tools and services around their core transaction businesses—such as information on depth of book and around order flow and market quality. Ultimately, these efforts are focused on finding new ways to create value and extract revenue from the exchanges’ core traditional execution

business—a way to add margins back to a commodity business. At the end of the day, this will only drive more pressure towards commoditization of the core business as exchanges compete to capture more order flow not for the revenue that can be earned on transactions charges, but for the revenue that can be earned on data sales—the exchange with the most trading activity will have the most valuable data.

The second IP related aspect of information is with regard to proprietary indices. This area is interesting for two reasons. First, IP protection really focuses around trade marks and trade secrets. Second, there have been a lot of developments recently. We all are familiar with the “blue chip” Dow Jones Industrial Average (the “DOW”)—in fact, it just recently broke through the 12,000 level for the first time last week! We also know the S&P500 index of large capitalization companies and the Russell 2000 small cap index. Not only do these indices serve as barometers for investors to follow various segments of the markets, they also serve as reference indices for derivative contracts such as futures, swaps and options, and for passive investment vehicles like mutual funds and ETFs.

To utilize an index as a reference benchmark for cash-settled derivatives, exchanges pay the index owner a fee—generally on a per contract basis. Mutual funds and ETFs generally pay a percentage of assets. Further, exchanges historically have paid transactions based licensing fees to the index providers for trades in ETFs and ETF options. This has changed recently as a result of a court decision last year, which was upheld earlier this year on appeal, that held that index owners are not owed payment for ETF options transactions. Essentially, the courts determined that an Index Provider’s intellectual property rights in an Index did not extend to the trading of options on an ETF. This is not a blow to the validity of the Index Provider’s claim that an Index takes substantial investment of financial and creative resources or to the strength of any associated marks, but rather a strong stance as to the reach of that intellectual property after the Index Provider has authorized the creation of an exchange traded fund that tracks the index. Since ETF options are among the most actively traded in the US (and even the world), it is estimated that this result cost index licensors tens of millions of dollars in annual revenue. Index owners will need to adapt to this new environment.

While several of the exchanges own indices that track the performance of their listings, and have begun to license these products more aggressively to serve as the basis of financial instruments, Amex has taken that approach one step further by creating indices specifically to serve as the basis for financial products, and licensing those indices for ETFs, options and other derivatives. While we started this practice back in the 1980s to support index options trading, probably the best example of this is our more recent family of Intellidexes, which are quantitative, strategy-based indices that attempt to outperform indices designed to passively replicate an entire segment of the financial markets using a proprietary, quantitative stock selection process. We have licensed these indices to create a series of ETFs, with over \$3bn in assets under management. In all, Amex owns roughly 75 indices which we license for financial products. To protect our intellectual property rights in these and other indices we have created, we typically trademark and service mark the brands. Recently, we have seen patent applications covering different indexing approaches. We’ll have to wait and see if they get approval. In any case, this area of strategy based indexing is growing extremely quickly, driven primarily by the tremendous growth in ETF assets, and the demand for ETFs that provide a more “active” approach to investing than those based on traditional passive benchmarks.

This discussion of ETFs is a good segue to the final area where we see innovation coming—new financial product structures. Here is the area where patents have begun to play an increasing role. When Amex introduced the first ETF back in January, 1993, it was the culmination of several years’ effort. Much time was spent developing the product structure, the systems to support the structure and the rules to govern trading in the products. At the time, Amex thought very hard about whether to patent what we had developed. However, there really was not much acceptance of business method patents at that time, so we decided against it.

Today, ETFs are a global phenomenon, with 600 ETFs listed on 36 exchanges around the world, holding one-half *trillion* dollars in assets, as of July 1. How differently the market might have developed had we applied for and been granted patent protection is an interesting question. However, I think it is clear that had we applied for and been issued patent protection, the already significant impact ETFs has had on the Amex would have been even greater.

Since the SPDR was introduced, business method patents have become much more accepted. The 1998 landmark decision in the appeal of *State Street Bank v. Signature Financial Group* essentially cleared the way for wide acceptance of business method patents. If you look at the number of patent applications filed and patents issued under class 705, the U.S. Patent and Trademark Office's classification number under which most business method patents fall, you'll see the following. For applications filed: 1996 – 584; 2000 – 7800; 2005 – 6226. A truly astounding change over just 10 years. On the issuance side, the picture is similar: 1996 – 144; 2000 – 899; 2005 – 1001. Today, there are a number of product structures that have been the basis of patent applications and issuances. Typically, the applicants are financial firms like banks or broker dealers who issue shares in new structures to investors, and seek to protect their innovative structures from being copied by competitors. So, for example, Goldman Sachs and Deutsche Bank each have filed patent applications covering methods for packaging for exchange trading indices of commodity futures in an ETF-like structure. Bank of New York has been issued a patent on a trust structure for similar packaging for trading individual commodities and currencies. By so packaging these products, the arcane and inaccessible world of commodities investments suddenly became open and available to institutions and individuals alike.

As the competition to innovate product structures continues, and as companies turn more and more towards patent protection for their innovations, there are bound to be conflicts and challenges between parties with conflicting solutions. As patents issue on these competing structures, it will be interesting to see how these conflicts are resolved, and what impact it will have on the products' success.

In our experience, there are a couple of examples you can look at as to how these things might go. First, consider the patents that were issued to a small group called Mopex in 1998 and 2000. The owners of these patents claimed they covered a broad range of ETFs that came after the original SPDR ETF. As the leader in the ETF marketplace and home to the great bulk of the ETF listings, Amex challenged the validity of the patents, and ultimately prevailed. Mopex didn't collect anything on their patents. At the other end of the spectrum, Cantor Fitzgerald, the large global financial services company, acquired several years back a patent covering electronic futures trading and clearing that was issued to Susan Wagner in 1990 some 10 years after she left the employ of the CFTC, where she came across countless examples of prior art. Ultimately, the Wagner patent also proved to be invalid, but not until after Cantor had collected nearly \$40 million in licensing fees from futures exchanges. Cantor only paid \$3 million for it. I guess even an invalid patent can be lucrative if defended aggressively enough!

I'll end with one final example of a new product platform that we've developed, which I think you'll find interesting. As I mentioned earlier, much of the recent ETF offerings have been based on what we like to call "strategy" based indices like the Amex Intellidexes. Beyond these, there is significant demand for truly actively managed ETFs—funds not designed to track an index, even a strategy based index—but managed by an investment adviser who uses his or her own judgment to select stocks in an attempt to outperform the market. There are real issues around an actively managed ETF. Investment advisors don't want to reveal their holdings, or more importantly, changes in their holdings, for fear that others might take advantage of this information to trade against them ("front running") or imitate their investment strategy independently, without compensating the manager ("free riding"). However, ETFs, which trade in the secondary market like shares of stock, have been hugely successful exactly because their holdings *are* known, which allows for very efficient pricing and trading in the secondary market.

The problem for actively managed ETFs, then, is how to bridge this gap between the investor's need for transparent pricing and the advisor's need to maintain portfolio secrecy. The Amex has spent the last six years developing a solution to this problem. I won't get into detail here, but essentially we have developed a strategy for getting sufficient information into the marketplace to allow market participants to effectively price and hedge the actively managed ETF shares without disclosing too much information that would enable someone outside the fund to decipher the fund's trading or investment strategy. We have filed for several patents on various aspects of our proposed solution. Two patents have issued to date, covering most of the key elements, and we are optimistic that the others have a very good chance of issuing as well. We have had very positive discussions with numerous fund companies about our approach and recently signed our first licensing agreement. We are looking forward to working with this first issuer to get SEC approval for an actively managed ETF.

So with that, let me just conclude by saying thank you and enjoy your dinner.