

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45803; File No. SR-ISE-2002-01]

### Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment No. 1 thereto by the International Securities Exchange LLC To Restructure From a Limited Liability Company to a Corporation

April 23, 2002.

#### I. Introduction

On January 11, 2002, the International Securities Exchange LLC ("ISE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change<sup>3</sup> to restructure from a limited liability company to a corporation and to "demutualize" by separating the equity interest in the Exchange from members' trading rights. On March 5, 2002, the Exchange filed Amendment No. 1 to the proposed rule change.<sup>4</sup> The proposed rule change, as amended, was published for comment in the **Federal Register** on March 15, 2002.<sup>5</sup> The Commission received no comments on the proposed rule change. This order approves the proposed rule change, as amended.

#### II. Description of the Proposal

The ISE is currently structured as a limited liability company ("LLC"), in which memberships encompass both trading rights and equity ownership. The Exchange plans to restructure from

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> The text of the proposed rule change consists of: (1) A new Certificate of Incorporation; (2) a new Constitution; and (3) amendments to the Exchange's Rules.

<sup>4</sup> See letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated March 4, 2002 ("Amendment No. 1"). In Amendment No. 1, the Exchange expanded the concentration limits regarding ownership of the Class A Common Stock of its proposed corporation. Specifically, the Exchange amended the proposed rule change to include a general prohibition on the voting rights with respect to stock that a person owns above a 20 percent ceiling. However, the Exchange states that its Board of Directors ("Board") would be able to exempt a person from the voting limit if such an exemption generally would be consistent with the Exchange's self-regulatory responsibilities. The Board would not be able to grant an exemption to: members; their affiliates; or persons subject to a statutory disqualification. In addition, Amendment No. 1 specifies that any "poison pill" the new corporation adopts will be subject to prior Commission approval.

<sup>5</sup> See Securities Exchange Act Release No. 45529 (March 8, 2002), 67 FR 11732.

a limited liability company ("Old ISE") to a Delaware stockholder corporation ("New ISE") and to demutualize by separating the equity interest in the Exchange from members' trading rights. Newly issued Class A Common Stock would represent the equity ownership in ISE and newly issued Class B Common Stock would represent the trading rights on ISE. The members of Old ISE would become stockholders of New ISE. New ISE may issue classes of preferred stock in the future, the terms of which would be defined by the Board and filed with the Commission for approval.

In addition, the Exchange has adopted the following interpretation of its Rules:

Upon reorganization, the Exchange would be a Delaware corporation. Pursuant to Paragraph (a)(ii) of Section II of the Exchange's Certificate of Incorporation, the holders of the Exchange's Class A Common Stock "would be entitled to receive, when and if declared by the Board of Directors, out of the assets of [New ISE] which are by law available therefor, dividends payable either in cash, in stock or otherwise." The Exchange states its policy is that any revenues it receives from regulatory fees or regulatory penalties: would be segregated; would be applied to fund the legal, regulatory and surveillance operations of the Exchange; and would not be used to pay dividends to the holders of the Class A Common Stock.

##### A. Class B Common Stock

The Class B Common Stock would confer upon holders trading privileges and specified voting rights associated with the memberships in Old ISE. The Class B shares would be issued in three series corresponding with the existing membership types. Accordingly, each Class A Membership Interest (Primary Market Maker ("PMM") Members) would receive one share of Class B Common Stock, Series B-1 (the "Series B-1 Stock"); each Class B Membership Interest (Competitive Market Maker ("CMM") Members) would receive one share of Class B Common Stock, Series B-2 (the "Series B-2 Stock"); and each Class C Membership Interest (Electronic Access Members ("EAM")) would receive one share of Class B Common Stock, Series B-3 (the "Series B-3 Stock").

Series B-1 Stock holders and Series B-2 Stock holders would have voting rights with respect to actions affecting the number of issued shares of Series B-1 Stock and Series B-2 Stock (the "Core Rights"). The holders of each series of Class B Common Stock would have the same trading privileges they currently hold as PMMs, CMMs, and EAMs.

A holder of Class B Common Stock, together with any affiliate, would not be permitted to own more than 20% of

Series B-1 Stock or Series B-2 Stock. ISE Founders<sup>6</sup> would have a temporary exemption, not to extend past May 26, 2010, from these ownership concentration limits. Founders, however, would have no voting rights, other than a vote related to Core Rights, for any shares in excess of 20% of the Series B-1 Stock or 20% of the Series B-2 Stock.

##### B. Class A Common Stock

In addition to receiving a share of Series B-1 common stock, each PMM will also receive several shares of Class A Common Stock. The holders of Class A Common Stock would have the right to vote on any matter that requires a vote of the stockholders of New ISE, other than votes with respect to Core Rights. If a holder of Class A Common Stock, together with any affiliate, owns more than 20% of the Class A Common Stock, the holder would have no voting rights for shares owned in excess of the 20% concentration limit. The New ISE Board, however, may approve an exemption to this prohibition for any person other than a New ISE member, an affiliate of a New ISE member, or a person subject to a statutory disqualification under Section 3(a)(3) of the Act,<sup>7</sup> if the Board determines that such an exemption generally would be consistent with the New ISE's self-regulatory responsibilities. ISE Founders would have a temporary exemption, not to extend past May 26, 2010, from the voting limitation on Class A Common Stock shares owned in excess of 20%, but only with respect to any vote regarding any merger, consolidation, or dissolution of the New ISE or any sale of all or substantially all of the assets of the New ISE.

##### C. Transfer of Memberships

In addition, the Exchange proposes to eliminate the bid/offer system of selling memberships and to eliminate the claims process and deposit requirements for sales, transfer, and leases. The Exchange proposes to allow members to negotiate their own purchases and sales, subject to the purchase or transfer agreement being filed with, and approved by, the Exchange.

##### D. Election of the Board of Directors

The size and composition of the Board of Directors of New ISE would

<sup>6</sup> As defined in the New ISE Constitution, the term "Founder" means a person or entity that purchased the former Class A or Class B Memberships directly from the Exchange on or prior to August 1, 1998, but only with respect to his or its ownership of such memberships.

<sup>7</sup> 15 U.S.C. 78c(a)(3).

remain the same following the demutualization. In future elections, the holders of the Class B Common Stock would elect six directors: two directors elected by the holders of Series B-1 Stock; two directors elected by the holders of Series B-2 Stock; and two directors elected by the holders of Series B-3 Stock. The holders of the Class A Common Stock would elect nine directors: eight non-industry directors (including at least two who would be public representatives) and the Chief Executive Officer. As opposed to the current structure, PMMs, CMMs, and EAMs would have the right to vote for the non-industry directors only to the extent they own Class A Common Stock. A nominating committee consisting of representatives of holders of the Series B Common Stock would select the nominees for Series B directors, and the non-industry directors on the Board would select the nominees for non-industry directors. Holders of the appropriate classes of common stock also would be able to nominate rival candidates for the Board.

### III. Discussion

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>8</sup> In particular, the Commission believes that the proposed rule change is consistent with section 6(b) of the Act,<sup>9</sup> in that that it is designed to (1) assure fair representation of its members in the selection of an exchange's directors and administration of its affairs and provide that, among other things, one or more directors shall be representative of investors and not be associated with the exchange, or with a broker or dealer; (2) prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transaction in securities, to remove impediments to and perfect the mechanism for a free and open market and a national market system; and (3) protect investors and the public interest.

#### A. Fair Representation of Members

Section 6(b)(3) of the Act requires that the rules of an exchange assure fair representation of its members in the selection of its directors and

administration of its affairs and provide that one or more directors be representative of issuers and investors and not be associated with a member of the exchange, or with a broker or dealer.<sup>10</sup>

The size and composition of the Board of Directors of New ISE would remain the same following the demutualization; the Board would continue to consist of 15 directors and initially will consist of the current Board of Old ISE. In future elections, the holders of the Class B Common Stock will elect six directors: two directors elected by the holders of Series B-1 Stock; two directors elected by the holders of Series B-2 Stock; and two directors elected by the holders of Series B-3 Stock. The nominations of these six directors would be made by the New ISE nominating committee, which would be comprised of one Series B-1 Common Stock representative, one Series B-2 Common Stock representative, and one Series B-3 Common Stock representative. Persons may also be nominated to be Series B Directors by a petition signed by 5% or more of the holders of the Series of Class entitled to elect such persons.

The holders of the Class A Common Stock will elect nine directors: Eight non-industry directors (including at least two who would be public representatives) and the Chief Executive Officer. Nominees for election of the Non-Industry Board Directors, including Public Directors, would be selected by the Non-Industry Directors currently on the Board. Persons may also be nominated to be Non-Industry Directors by petition signed by 20% or more of the holders of Class A Common Stock. Thus, the Board would include six directors nominated and elected by members. In addition, the proposed New ISE Constitution provides that the number of non-industry members on the executive and audit committees equals or exceeds the number of industry members. The New ISE executive committee will consist of six directors, at least three of which will be non-industry directors and at least one of whom will be a public director.<sup>11</sup> In addition, the New ISE audit committee will consist of three to five directors, each of which will be a non-industry director, and at least one of the non-industry directors will be a public director.<sup>12</sup>

The Commission finds that the selection of 6 of the 15 directors on the New ISE's Board and the manner in

which such directors will be nominated and elected satisfies the fair representation requirement in Section 6(b)(3) of the Act.<sup>13</sup> Moreover, the Commission finds that the majority non-industry composition of the Board of the New ISE, together with the compositional balance on the committees, is sufficient to help assure that the Exchange actively works to protect the public's interest in the fairness of the securities markets and is consistent with Section 6(b)(3) of the Act.<sup>14</sup>

#### B. Concentration Limits

The ISE has also proposed concentration limits to restrict the number of shares that a stockholder, together with any affiliate, may own or vote. A holder of Class B Common Stock, together with any affiliate, would not be permitted to own more than 20% of Series B-1 Stock or Series B-2 Stock. ISE Founders would have a temporary exemption, not to extend past May 26, 2010, from the ownership concentration limits. Founders, however, would have no voting rights, other than a vote related to Core Rights, for any shares in excess of 20% of the Series B-1 Stock or 20% of the Series B-2 Stock.

If a holder of Class A Common Stock, together with any affiliate, owns more than 20% of the Class A Common Stock, the holder would have no voting rights for shares owned in excess of the 20% concentration limit. The New ISE Board, however, would be permitted to approve an exemption to this prohibition for any person other than a New ISE member, an affiliate of a New ISE member, or a person subject to a statutory disqualification under Section 3(a)(3) of the Act,<sup>15</sup> if the Board determines that such an exemption generally would be consistent with New ISE's self-regulatory responsibilities. ISE Founders would have a temporary exemption, not to extend past May 26, 2010, from the voting limitation on Class A Common Stock shares owned in excess of 20%, but only with respect to any vote regarding any merger, consolidation, or dissolution of the New ISE or any sale of all or substantially all of the assets of the New ISE.

The Commission finds that the proposed restrictions on the ownership and voting on members, who are also subject to regulation by the Exchange, is consistent with the requirements of Section 6(b) of the Act.<sup>16</sup> Moreover, the Commission believes that the proposed

<sup>8</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>9</sup> 15 U.S.C. 78f(b).

<sup>10</sup> 15 U.S.C. 78f(b)(3).

<sup>11</sup> New ISE Constitution, Article V, Section 5.2.

<sup>12</sup> New ISE Constitution, Article V, Section 5.4.

<sup>13</sup> 15 U.S.C. 78f(b)(3).

<sup>14</sup> 15 U.S.C. 78f(b)(3).

<sup>15</sup> 15 U.S.C. 78c(a)(3).

<sup>16</sup> 15 U.S.C. 78f(b)(1).

ownership and voting concentration limits on other shareholders will minimize the potential that the control of the Exchange by one or a few shareholders would impair the Exchange's ability to carry out its self-regulatory obligations.

Finally, the Commission notes that New ISE, like Old ISE, will not be structured to provide its shareholders a profit from revenue generated by the Exchange as a result of regulatory fees or penalties imposed on Exchange members. The New ISE's policy is that any revenues it receives from regulatory fees or regulatory penalties: (1) Would be segregated; (2) would be applied to fund the legal, regulatory, and surveillance operations of the Exchange; and (3) would not be used to pay dividends to the holders of Class A Common Stock. In addition, the proposed rules of New ISE do not change any trading privileges of its members. The Commission finds that the allocation and use of regulatory fees or regulatory penalties is consistent with Section 6(b)(3) of the Act<sup>17</sup> because it will ensure that the regulatory authority of the Exchange is not used improperly to benefit the shareholders.

#### IV. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and rules and regulations thereunder.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>18</sup> that the proposed rule change (SR-ISE-2002-01), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>19</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45807; File No. SR-NASD-2002-51]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Revisions to the Limited Representative—Equity Trader (Series 55) Examination Program

April 24, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on April 10, 2002, the National Association of Securities Dealers, Inc. ("NASD"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation"), filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. NASD Regulation has designated this proposed rule change as one constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization under section 19(b)(3)(A)(i) of the Act,<sup>3</sup> and Rule 19b-4(f)(1)<sup>4</sup> thereunder, which renders the proposal effective upon filing with the Commission.<sup>5</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

NASD Regulation is proposing revisions to the Limited Representative—Equity Trader (Series 55) examination program. The proposed revisions update the Series 55 examination study outline,<sup>6</sup> selection

specifications,<sup>7</sup> and question bank<sup>8</sup> to reflect changes to the laws, rules, and regulations covered by the examination. The proposed revisions do not result in any textual changes to the By-Laws, Schedules to the By-Laws, or Rules of NASD Regulation or the NASD.

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NASD Regulation included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD Regulation has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

##### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

###### 1. Purpose

Pursuant to Section 15A(g)(3) of the Act,<sup>9</sup> which requires the NASD to prescribe standards of training, experience, and competence for persons associated with NASD members, the NASD has developed examinations, and administers examinations developed by other self-regulatory organizations, that are designed to establish that persons associated with NASD members have attained specified levels of competence and knowledge. NASD Regulation periodically reviews the content of the examinations to determine whether revisions are necessary or appropriate in view of changes pertaining to the subject matter covered by the examinations.

The Series 55 examination is required, with certain limited exceptions, for registered representatives who are engaged in proprietary trading, the execution of transactions on an agency basis, or the direct supervision of such activities, with respect to transactions in equity,

<sup>7</sup> NASD Regulation has requested confidential treatment for the Series 55 examination, and thus the specifications are omitted from this filing. The specifications have been filed separately with the Commission pursuant to Rule 24b-2 under the Act. 17 CFR 240.24b-2.

<sup>8</sup> Based upon instruction from the Commission staff, NASD Regulation is not filing the question bank for Commission review. See Letter to Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, from Belinda Blaine, Associate Director, Division of Market Regulation, SEC, dated July 24, 2000.

<sup>9</sup> 15 U.S.C. 78o-3(g)(3).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A)(i).

<sup>4</sup> 17 CFR 240.19b-4(f)(1).

<sup>5</sup> See Letter to Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, from Belinda Blaine, Associate Director, Division of Market Regulation, SEC, dated July 24, 2000.

<sup>6</sup> The text of the Series 55 study outline is available at NASD Regulation and at the Commission.

<sup>17</sup> 15 U.S.C. 78f(b)(3).

<sup>18</sup> 15 U.S.C. 78s(b)(2).

<sup>19</sup> 17 CFR 200.30-3(a)(12).