practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that this proposed rule change will ensure that members' Representative contact information is accurate and that NASD can timely contact members.

B. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others

Comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which NASD consents, the Commission will:

A. By order approve such proposed rule change, or

B. Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments may also be submitted electronically at the following e-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. SR–NASD–2003–184. This file number should be included on the subject line if e-mail is used. To help the Commission process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to file number SR-NASD–2003–184 and should be submitted by February 17, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[5]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 04–1666 Filed 1–26–04; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–49098; File No. SR–PHLX–2003–73]

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 Thereto Relating to the Demutualization of the Philadelphia Stock Exchange, Inc.

January 16, 2004.

I. Introduction

On November 17, 2003, the Philadelphia Stock Exchange, Inc. (''Phlx'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission''), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1] and Rule 19b–4 thereunder,[2] a proposed rule change to: (1) Amend its Certificate of Incorporation to eliminate a reference to ''not for profit'' and a restriction on the payment of dividends (''Plan of Conversion'' and such amendments to the Certificate of Incorporation, the ''Conversion Amendment''); and (2) merge a newly-created, wholly-owned shell subsidiary of the Phlx with and into the Phlx, with the Phlx surviving as a demutualized Delaware stock corporation (''Merger'' and together with the Plan of Conversion, the ''Plan of Demutualization'') pursuant to an Agreement and Plan of Merger (''Merger Agreement''). On November 24, 2003, the Phlx submitted Amendment No. 1 to the proposed rule change.[3] On November 26, 2003, the Phlx submitted Amendment No. 2 to the proposed rule change.[4] On December 3, 2003, the proposed rule change was published for comment in the **Federal Register**.[5] On December 29, 2003, the Phlx submitted Amendment No. 3 to the proposed rule change.[6] The Commission received one comment letter in response to the proposed rule change.[7] This order approves the proposed rule change.

II. Description of Proposed Rule Change

The purpose of the proposed rule change is to implement the Plan of Demutualization. In connection with the Plan of Demutualization, trading privileges will be separated from corporate ownership of the Phlx and will be made available exclusively through trading permits. [8]

As a result of the demutualization, a total of 50,500 shares of Class A Common Stock (100 shares per Seat) will be issued to existing equitable Seat holders and will represent 100% of the common equity ownership in the Phlx outstanding immediately after the demutualization. In addition, all Members and holders of equity trading permits (''ETPs'') who are affiliated with Member Organizations and are not suspended will be entitled to receive

---

[5] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* Letter from Edith Halihan, Deputy General Counsel, Phlx, to Nancy Sanow, Assistant Director, Division of Market Regulation (''Division''), Commission, dated November 21, 2003. (''Amendment No. 1''). In Amendment No. 1, the Phlx made technical conforming changes to the exhibits to the proposed rule change.

[4] *See* Letter from Edith Halihan, Deputy General Counsel, Phlx, to Nancy Sanow, Assistant Director, Division, Commission, dated November 26, 2003 (''Amendment No. 2''). In Amendment No. 2, the Phlx amended the proposed rule change to reflect that on November 25, 2003, the members of the Phlx (as that term is defined in Section I–1(b) of the current By-laws of the Phlx, the ''Members'') approved the Plan of Conversion, the Merger, and all transactions to be effected in connection therewith. Also, on November 18, 2003, holders of equitable title (''Owners'') to memberships in the Phlx (each such membership a ''Seat'') voted to approve the Plan of Demutualization as a whole.

[5] *See* Securities Exchange Act Release No. 48847 (November 26, 2003), 68 FR 67720 (''Notice'').

[6] *See* Letter from Edith Halihan, Deputy General Counsel, Phlx, to Nancy Sanow, Assistant Director, Division, Commission, dated December 23, 2003 (''Amendment No. 3''). In Amendment No. 3 the Phlx formally submitted the Conversion Amendment as part of the proposed rule change.

[7] *See* Letter from Joseph Carapico, General Partner, Andrew W. Snyder, General Partner and Richard B. Feinberg, Limited Partner, Penn Mont Securities, to Jonathan G. Katz, Secretary, Commission, dated December 19, 2003 (''Penn Mont Letter'').

[8] The Exchange, however, plans to retain its existing Foreign Currency Option (''FCO'') participations (as defined in section 1–1(i) of the amended By-laws). After the demutualization, the ability to trade FCOs on the Phlx will also be available through a Series A–1 Permit, as set forth in proposed Rule 908(b).

new Series A–1 Permits (''Permits'') to enable them to continue their trading activities on the Exchange without interruption.[9] Similarly, Member Organizations will maintain their status as members of the Phlx upon their compliance with certain deposit and registration requirements.

The Exchange proposes to effect the Plan of Demutualization for a number of reasons, including to expand its sources of capital and revenue; to facilitate its ability to enter into relationships with strategic or financial partners who may be crucial for the Exchange's future development, capital formation and viability; to facilitate the introduction of new products and thus potentially increase transaction volume and Exchange revenues; and to better position itself to react to new opportunities and challenges.

The Exchange represents that, after the effective date of the demutualization, it will continue to be a national securities exchange registered under section 6 of the Act.[10] The Exchange also represents that, except as is necessary to implement the new permit structure to replace the existing structure of owning and leasing seats as a basis for trading rights and Exchange memberships, it is not proposing any significant changes to its existing operational and trading structure in connection with the demutualization. The Exchange further states that the demutualization will not affect its functions as a self-regulatory organization (''SRO'') and will not affect the designation of the Exchange as ''designated examining authority'' (''DEA'') for those Member Organizations for which the Exchange currently is the DEA. Moreover, the Exchange notes that it is not proposing any changes to its existing disciplinary system, fines or the related appellate process in connection with the Plan of Demutualization.[11]

A. Capital Structure of the Demutualized Phlx

Changes to the capital structure of the Phlx, as set forth in Article FOURTH of the proposed Certificate of Incorporation, generally reflect the proposed conversion of the Phlx from a non-stock Delaware corporation to a demutualized Delaware stock corporation.

Pursuant to Article FOURTH of the proposed Certificate of Incorporation, after the Merger, the authorized capital stock of the Phlx will consist of:

- 50,500 shares of Class A Common Stock;
- 949,500 shares of Class B Common Stock, par value $0.01 per share (''Class B Common Stock,'' and together with the Class A Common Stock, the ''Common Stock''); and
- 100,000 shares of preferred stock, par value $0.01 per share, one of which will be designated as ''Series A Preferred Stock.''

Upon consummation of the demutualization, the only capital stock outstanding will be the 50,500 shares of Class A Common Stock and the single share of Series A Preferred Stock. The Exchange proposes to authorize more shares of common stock (in the form of the Class B Common Stock) and preferred stock to allow for a more flexible approach to third-party investments and strategic relationships, which the Exchange believes will be critically important to its survival. The proposed Certificate of Incorporation will allow the Board of Governors to create and issue in the future additional classes or series of preferred stock without stockholder approval. In a separate undertaking, however, the Exchange has agreed to submit any such creation and issuance of additional classes or series of preferred stock to the Commission pursuant to section 19(b) of the Act.[12] The issuance and the sale, transfer or other disposition of the Exchange's capital stock will be subject to certain voting and ownership limitations, described below.

1. Common Stock

a. Class A Common Stock and Class B Common Stock

Pursuant to Article FOURTH (b)(i) of the proposed Certificate of Incorporation, the Class A Common Stock and the Class B Common Stock will be identical in all respects and will have equal rights and privileges, except for the right to receive the Contingent Dividend (as defined below). Pursuant to Article FOURTH (b)(vi) of the proposed Certificate of Incorporation, each share of Class A Common Stock will automatically convert into one share of Class B Common Stock on the third anniversary of the closing of the Plan of Demutualization (the ''Dividend Termination Date'').[13] The proposed Certificate of Incorporation will provide that, before the automatic conversion, the Exchange will have to notify the holders of the Class A Common Stock in accordance with certain specific requirements set forth in the Certificate of Incorporation.

b. Dividends (Including the Contingent Dividend)

Currently, the existing Certificate of Incorporation provides that the Phlx is ''not for profit'' and ''no capital stock shall ever be issued and no dividend shall ever be paid'' by the Phlx. After the demutualization, this restriction on paying dividends will be removed, and the Phlx's stockholders will have all dividend and other distribution rights of a stockholder in a Delaware stock corporation (except as may be limited by the rights any preferred stock may have, once issued).

Section 30–4 of the proposed By-laws, however, will prohibit the payment of dividends from any revenues the Phlx derives from regulatory fines, fees or penalties. The Exchange will apply this limitation to its net income, prospectively only, commencing with the fiscal year in which the Merger occurs.[14] To determine the amount of the limitation, the Phlx will first calculate: (i) the amount of regulatory fines, fees and penalties that it has accrued for the fiscal year in which the Merger occurs and later time periods (collectively, ''Regulatory Fee Amount'');[15] and (ii) the amount of

[9] Pursuant to Rule 23 of the current Phlx Rules, the Exchange has issued ETPs, four of which are currently outstanding. In the demutualization, these ETPs will be eliminated in accordance with current Rule 23 and pursuant to proposed Rule 971, and the rights and privileges of ETPs will be conferred on existing ETP holders by Permits.

[10] 15 U.S.C. 78f.

[11] On January 7, 2004 the Exchange filed a proposed rule change pursuant to section 19(b) of the Act, SR–Phlx–2004–02, to adopt fees applicable to Series A–1 Permits and to make conforming changes to its fee schedule as a result of the demutualization. The Merger Agreement provides that the effectiveness of the Merger (and thus the Plan of Demutualization in general), among other things, is conditioned upon such filing becoming effective or being approved by the Commission, as the case may be. This proposed rule change was filed as a fee change pursuant to Section 19(b)(3)(A)(ii) of the Act, 15 U.S.C. 78(s)(b)(3)(A)(ii).

[12] 15 U.S.C. 78s(b).

[13] The automatic conversion will be effected as a matter of administrative convenience to consolidate the Common Stock into a single class after the Contingent Dividend will no longer be potentially payable (*i.e.*, on the Dividend Termination Date). At the time of conversion, because the Contingent Dividend will no longer be potentially payable, the Class A Common Stock and the Class B Common Stock will have identical rights and privileges.

[14] The Exchange indicates that its rationales for applying this restriction prospectively are: (i) Prior to the effectiveness of the Conversion Amendment, the Exchange's Certificate of Incorporation has provided that the Exchange is ''not for profit'' and has prohibited the payment of dividends altogether; and (ii) the Exchange has not compiled, and could not reasonably reconstruct, the information necessary for determining Regulatory Costs and Regulatory Fee Amounts (as defined herein) for prior periods.

[15] According to the Exchange, regulatory fines and penalties will include such amounts imposed by the Business Conduct Committee and/or the Phlx's Board of Governors (''Board''), but not late charges or interest charged. Regulatory fees shall include the Exchange's fees relating to registered

Continued

regulatory costs and expenses [16] accrued for the same time period (collectively, ''Regulatory Cost Amount''). The Exchange will determine the applicable restriction by determining the excess, if any, of the Regulatory Fee Amount over the Regulatory Cost Amount, and applying that to the amount of its net income for the fiscal year in which the Merger occurs and later periods. The Exchange advises that this restriction concerning the payment of dividends shall not prevent it from paying dividends from: (i) Capital, surplus or retained earnings of the Exchange which were (without regard to this restriction) available for the payment of dividends at the time of the Merger; or (ii) capital contributions or other capital items, in each case, no portion of which is attributable to Regulatory Fees.

Pursuant to Article FOURTH (b)(ii) of the proposed Certificate of Incorporation, the Class A Common Stock will carry with it the right to a contingent dividend (the ''Contingent Dividend'') payable in cash if a Liquidity Event occurs on or before the Dividend Termination Date. A ''Liquidity Event'' will be any investment of net cash proceeds in the Phlx's capital or that of one of its subsidiaries, either by means of a public offering or private placement of the common or preferred stock of the Phlx or the common stock or other securities of the subsidiary. The amount payable as the Contingent Dividend will depend, as follows, on the aggregate amount of net cash proceeds received by the Phlx and/or the subsidiary from all Liquidity Events occurring on or before the Dividend Termination Date:

• If the aggregate net cash proceeds will be at least $50 million but less than $100 million, the amount payable as a Contingent Dividend will be $7,500 for each 100 shares of Class A Common Stock ($3,787,500 in the aggregate).

• If the aggregate net cash proceeds will be at least $100 million but less than $150 million, the amount payable as a Contingent Dividend will be $17,500 for each 100 shares of Class A Common Stock then outstanding ($8,837,500 in the aggregate).

• If the aggregate net cash proceeds will be at least $150 million, the amount payable as a Contingent Dividend will be $29,700 for each 100 shares of Class A Common Stock then outstanding ($14,998,500 million in the aggregate).

If no Liquidity Event occurs on or before the Dividend Termination Date, the right to receive the Contingent Dividend will terminate without further action on behalf of the Exchange and the Class A Common Stock will be automatically converted into Class B Common Stock, as indicated above.

c. Liquidation Rights and Preferences

Currently, Owners have the right to receive all distributions upon a liquidation of the Exchange, on the basis of their pro-rata interest in the Phlx, except as such right may be limited by certain rights of the holders of FCO participations. After the demutualization, the Phlx Common Stock will have the right to receive all distributions upon a liquidation of the Phlx, subject to the rights of any preferred stock that may be issued in the future and the rights of the holder of the Series A Preferred Stock.

d. Voting Rights/Election of Directors

Currently, non-Member Owners do not have voting rights under the Exchange's existing Certificate of Incorporation, By-laws and Rules with respect to any matters relating to the Exchange, with certain very limited exceptions.[17] After the demutualization, pursuant to Article FOURTH (b)(iii) of the proposed Certificate of Incorporation, the holders of Phlx Common Stock will vote on all matters on which stockholders are entitled to vote except for the election and removal of the On-Floor Governors, and, in the case of a contest for the position, the selection of the On-Floor Vice Chairman of the Exchange.

The holders of the Class A Common Stock and Class B Common Stock will vote together as a single class on all matters, except that: (i) any amendment, alteration or repeal of any of the provisions of the proposed Certificate of Incorporation that adversely affects the rights, powers or privileges of the Class A Common Stock (but not of the Class B Common Stock) will require the affirmative vote of a majority of the shares of the Class A Common Stock then outstanding, voting separately as a class; and (ii) any amendment, alteration or repeal of any of the provisions of the proposed Certificate of Incorporation that adversely affects the rights, powers or privileges of the Class B Common Stock (but not of the Class A Common Stock) will require the affirmative vote of a majority of the shares of Class B Common Stock then outstanding, voting separately as a class.

In addition, pursuant to Section 22–1 of the proposed By-laws, the By-Laws may be amended by the affirmative vote of a majority of the entire Board of Governors, or by the affirmative vote of the holders of a majority of the shares of common stock then issued and outstanding, at any regular or special meeting of the Board of Governors or the stockholders (as the case may be). Unlike pursuant to Section 22–1 of the existing By-laws, after the demutualization, Members (or Member Organizations) will have no right to vote in relation to By-law amendments or to propose By-law amendments. The Phlx states that such change is consistent with the Exchange's proposed post-demutualization structure as a Delaware stock corporation in accordance with applicable Delaware law.

With respect to management equity awards, Section 6–1 of the proposed By-laws provides that, the Exchange will not at any time adopt any stock incentive or option plan or arrangement, or any other equity based compensation plan or arrangement, for the benefit of its governors or officers that authorizes the issuance of stock, stock options or any other securities exercisable or exchangeable for or convertible into any equity interest in the Exchange representing more than 10% of the Common Stock outstanding at such time.

e. Voting Limitations Regarding the Common Stock

Article FOURTH (b)(iii)(A) of the proposed Certificate of Incorporation provides that each stockholder will be entitled to one vote for each share of Common Stock held of record on the books of the Phlx, subject to the applicable voting restrictions as described below. In connection with the demutualization, the Exchange proposes to include certain voting limitations as set forth in Article FOURTH (b)(iii)(B) of the proposed Certificate of Incorporation. The limitations will provide that, if any Person (as defined

representative registration (currently, initial, renewal and transfer fees), as well as its off-floor trader (currently, initial and annual) and examinations fees.

[16] In the Phlx's view, these amounts include costs reasonably related to the Exchange's regulatory function. Specifically, the Exchange intends to include the direct and allocated costs and expenses of the regulatory and enforcement groups as well as an allocation of the direct and allocated costs of technology, legal, compliance and other departments that support the regulatory and enforcement groups and work on regulatory projects. The Exchange's cost allocation methodology includes an employee's compensation and benefits-related costs and the overhead attributable to that employee, such as, for example, occupancy costs, office supplies, and administrative support and an allocation of management costs (again, adding, for example, the secretary's and managers' direct and allocated costs).

[17] In addition, existing contractual arrangements between Owners of Seats or Member Organizations, on the one hand, and non-Owner Members, on the other hand, such as leases or A–B–C agreements, in all but one case contain a provision that entitles the Seat Owner or the Member Organization, respectively, to direct the Member's vote with respect to the Plan of Demutualization.

below) either alone or together with its Related Persons (as defined below), at any time owns of record or beneficially, whether directly or indirectly, more than 20% of the then outstanding shares of Common Stock (such shares of Common Stock in excess of such 20% limit being hereinafter referred to as ''Excess Shares''), that Person and its Related Persons will not have any right to vote, or to give any consent or proxy with respect to, the Excess Shares, and the Excess Shares will be deemed not to be present for the purposes of determining whether a quorum is present at any meeting or vote of the stockholders of the Exchange. For purposes of the proposed Certificate of Incorporation, ''Related Persons'' means: (i) with respect to any Person, all ''affiliates'' and ''associates'' of such Person (as such terms are defined in Rule 12b–2 under the Act);[18] (ii) with respect to any natural person constituting a ''member'' (as such term is defined in the Act) of the Exchange, any broker or dealer with which such member is associated; and (iii) any two or more Persons that have any agreement, arrangement or understanding (whether or not in writing) to act together for the purpose of acquiring, holding, voting or disposing of shares of common stock. The term ''Person'' will be defined in the proposed Certificate of Incorporation to mean an individual, partnership (general or limited), joint-stock company, corporation, limited liability company, trust or unincorporated organization, and a government or agency or political subdivision thereof.

Notwithstanding the foregoing, a Person, either alone or together with its Related Persons, owning of record or beneficially, whether directly or indirectly, more than 20% of the then outstanding shares of Common Stock will be allowed to exercise voting rights, and give proxies and consents, with respect to those shares exceeding 20%, provided that:

- such Person (and its Related Persons owning any Common Stock) has delivered to the Board of Governors a notice in writing, not less than 45 days (or any shorter period to which the Board of Governors shall expressly consent) before the proposed exercise of its voting rights, of its intention to do so; and
- before the intended exercise, the Board of Governors has adopted an amendment to the By-Laws adding a provision to expressly permit such Person's exercise of voting rights in excess of 20%; and the amendment has been filed with the Commission as a proposed rule change under Section 19(b) of the Act [19] and has become effective.

The Board of Governors will not be permitted to adopt any amendment to the proposed By-laws described in the foregoing paragraph unless the Board of Governors has determined that: (i) the exercise of those voting rights by the Person in question and/or its Related Persons will not impair the Exchange's ability to discharge its responsibilities under the Act and the rules and regulations thereunder and is otherwise in the best interests of the Exchange and its stockholders; (ii) the exercise of those voting rights by that Person and its Related Persons will not impair the Commission's ability to enforce the Act; and (iii) that Person and its relevant Related Persons are not subject to any applicable statutory disqualification. In making those determinations, the Board of Governors may impose on the Person in question and its Related Persons such conditions and restrictions as it may in its sole discretion deem necessary, appropriate or desirable in furtherance of the objectives of the Act and the governance of the Exchange. Under the proposed Certificate of Incorporation, however, in no event will a Person who is a Member of the Exchange, either alone or together with its Related Persons, be permitted to vote shares in excess of 20% of the outstanding Common Stock.[20]

f. Ownership Limitations, Notification Requirements and Transfer Requirements Regarding the Common Stock

Pursuant to Article FOURTH (b)(v) of the proposed Certificate of Incorporation, no Person, either alone or together with its Related Persons, will be allowed to own, of record or beneficially, directly or indirectly, more than 40% of the then outstanding shares of Common Stock of the Phlx and to the extent any Person (or its Related Persons) purports to own more than 40% of the then outstanding shares of common stock, that Person (and its Related Persons) will not be allowed to exercise any of the rights or privileges incident to the ownership of shares of common stock with respect to the shares exceeding the 40% limit, unless:

- such Person (as well as its Related Persons) has delivered to the Board of Governors a notice in writing, not less than 45 days (or such shorter period to which the Board of Governors expressly consents) before the acquisition of that ownership, of its intention to acquire the ownership; and
- before the intended exercise, the Board of Governors has adopted an amendment to the By-Laws, adding a provision to expressly permit that Person's ownership in excess of 40%, and the amendment has been filed with the Commission as a proposed rule change under Section 19(b) of the Act, which has become effective.

The Board of Governors will not be permitted to adopt any amendment to the proposed By-laws described in the foregoing paragraph unless the Board of Governors has determined that: (i) Such acquisition of such ownership by such Person in question and/or its Related Persons will not impair the Exchange's ability to discharge its responsibilities under the Act and the rules and regulations thereunder and is otherwise in the best interests of the Exchange and its stockholders; (ii) such acquisition of such ownership by such Person and its Related Persons will not impair the Commission's ability to enforce the Act; and (iii) that Person and its relevant Related Persons are not subject to any applicable statutory disqualification. In making those determinations, the Board of Governors may impose on the Person in question and its Related Persons such conditions and restrictions as it may in its sole discretion deem necessary, appropriate or desirable in furtherance of the objectives of the Act and the governance of the Exchange.

Unless the conditions specified above are met, if any Person exceeds the 40% threshold, either alone or together with its Related Persons, the Phlx will have the right, but not the obligation, to purchase from that Person and its Related Persons the shares of Common Stock that exceed the 40% threshold for a price equal to the par value of the shares of Common Stock.

In addition, pursuant to Article FOURTH (b)(v)(B) of the proposed Certificate of Incorporation, no Member, either alone or together with its Related Persons, will be allowed to own, of record or beneficially, directly or indirectly, more than 20% of the then outstanding shares of Common Stock of the Exchange. To the extent that any Member (or its Related Persons) purports to so own more than 20% of the then outstanding shares of Common Stock, that Member (and its Related Persons) will not be allowed to exercise any of the rights or privileges incident to the ownership of shares of Common Stock with respect to the shares exceeding the 20% limit.

[18] 17 CFR 240.12b–2.

[19] 15 U.S.C. 78s(b).

[20] *See* Section II.A.1.f. for a discussion regarding the ownership limitations placed on Members under the proposed Certificate of Incorporation.

If any Member exceeds the 20% threshold, either alone or together with its Related Persons, the Phlx will have the right, but not the obligation, to purchase from that Member and its Related Persons the shares of Common Stock that exceed the 20% threshold for a price equal to the par value of the shares of Common Stock. Also, unlike ownership by non-Members in excess of 40%, the proposed Certificate of Incorporation does not contain a proviso allowing for Members to own shares in excess of 20% with appropriate notification and a By-law amendment sanctioned by the Commission.

In addition, pursuant to Article FOURTH (b)(iv) and (v) of the proposed Certificate of Incorporation, any Person, either alone or together with its Related Persons, that at any time owns (whether by acquisition or by a change in the number of shares outstanding) of record or beneficially, directly or indirectly, 5% or more of the then outstanding shares of Common Stock will be required, immediately upon so owning 5% or more of the then outstanding shares of Common Stock, to give the Board of Governors written notice of that ownership and will be required to update the notice promptly after any ownership change. However, an updated notice will not have to be provided to the Board of Governors in the event of an increase or decrease of less than 1% (of the then outstanding shares of Common Stock) in the ownership percentage so reported (for that purpose, the increase or decrease will be measured cumulatively from the amount shown on the immediately preceding report) unless such increase or decrease of less than 1% results in such Person's owning more than 20% or more than 40% of the shares of Common Stock then outstanding (at a time when such Person so owned less than those percentages) or results in such Person's owning less than 20% or less than 40% of the shares of Common Stock then outstanding (at a time when such Person so owned more than those percentages). These voting and ownership limitations, together with the notification requirements, are intended to establish a system of supervision and control to effectively prevent acquisition of voting power of or assertion of control over the Exchange without the approval of both the Board of Governors and the Commission. In addition, the proposed 20% threshold on member ownership is designed to prevent any Member Organization from dominating the Exchange. These notification requirements will also allow the Exchange to fulfill its reporting obligations to the Commission [21] and to better monitor the voting and ownership limitations in the proposed Certificate of Incorporation described above.

g. Transfer Restrictions

Pursuant to Section 29–1 of the proposed By-laws, no stockholder of the Exchange may sell, transfer (by operation of law or otherwise) or otherwise dispose of any shares of Class A Common Stock except in blocks of 100 shares per sale, transfer or disposition. This transfer restriction is intended to ensure that the number of holders of common stock of the Exchange will not exceed the threshold for having to register the Exchange with the Commission under Section 12 of the Act.[22] The Exchange believes that, at least for some period of time after the demutualization, the obligation of being a public reporting company would be overly burdensome on the Exchange as compared to the advantages conferred by that status.

In addition, the Phlx states that Article 29 of the proposed By-laws contains other restrictions typical for a Delaware stock corporation to ensure compliance with the Securities Act of 1933 (''Securities Act''),[23] and to allow for efficient future marketing of the capital stock by an underwriter in connection with and after a potential initial public offering of shares of capital stock of the Exchange.[24] Accordingly, Section 29–2 of the proposed By-laws provides that after the demutualization, no sale, transfer or other disposition of the capital stock of the Exchange may be effected except: (i) Pursuant to an effective registration statement under the Securities Act and in accordance with all applicable state securities laws; (ii) upon delivery to the Exchange of an opinion of counsel satisfactory to the Board that such sale, transfer or other disposition may be effected pursuant to a valid exemption from the registration requirements of the Securities Act and all applicable state securities laws; (iii) upon delivery to the Exchange of such certificates or other documentation as counsel to the Exchange shall deem necessary or appropriate in order to ensure that such sale, transfer or other disposition complies with the Securities Act and all applicable state securities laws; or (iv) pursuant to such procedures as the Chairman of the Board (or his designee) may adopt from time to time with respect to such transactions. In addition, no sale, transfer or other disposition of the capital stock of the Exchange may be effected by any holder of such stock until all amounts due and owing by such holder to the Exchange (whether any such amounts relate to such holder's status as a stockholder, Member, participant or Member (or participant) Organization of the Exchange or otherwise) shall have been paid in full.

In addition, Section 29–3 of the proposed By-laws provides that no stockholders, if requested by the Exchange or any underwriter of equity securities of the Exchange, may sell or otherwise transfer or dispose of any shares of capital stock of the Exchange held by such stockholder during the 180-day period following the effective date of a registration statement of the Exchange filed under the Securities Act in respect of that class of capital stock. If requested by the Exchange or any such underwriters, each stockholder will be required to execute an agreement to the foregoing effect. The Exchange may impose stop-transfer instructions with respect to the shares (or securities) subject to the foregoing restriction until the end of said 180-day period.

2. Series A Preferred Stock/Phlx Member Voting Trust

a. Designation and Issuance of Series A Preferred Stock to Phlx Member Voting Trust/Trust Agreement

Article FOURTH of the proposed Certificate of Incorporation will designate one share of preferred stock as the ''Series A Preferred Stock.'' The Series A Preferred Stock will have the sole power to: (i) Select the On-Floor Governors, and (ii) remove the On-Floor Governors in accordance with specified procedures in connection with the removal of Governors.

As set forth in the Trust Agreement, at the effective time of the Merger, the Exchange will issue the share of Series A Preferred Stock to the Trust. Pursuant to Section 4.1 of the Trust Agreement, the Trustee of the Trust will have to vote the share of Series A Preferred Stock with respect to the designated nominees for election as On-Floor Governors, or the removal of On-Floor Governors, as the case may be, as directed by the vote of the Member Organization Representatives of Member Organizations entitled to vote.

The single share of the Series A Preferred Stock, issued to the Trust governed by the Trust Agreement, is designed to facilitate the exercise by Members and Member Organizations of their rights to fair representation in the

[21] 17 CFR 249.1a.

[22] 15 U.S.C. 78*l*.

[23] 15 U.S.C. 77.

[24] The Phlx notes that no such transaction is currently contemplated at this time.

selection and removal of On-Floor Governors of the Exchange and to facilitate the administration of the affairs of the Exchange in accordance with the Act. The voting arrangements implemented through the Trust Agreement and the Series A Preferred Stock are designed to give ''members'' (as defined in Section 3(a)(3)(A) of the Act) [25] a voice in the management of the Exchange after the demutualization. These arrangements are necessary for two reasons: (i) Under Delaware law, only stockholders can elect the directors of a Delaware corporation; and (ii) after the demutualization, Members and Member Organizations that were not Owners at the time of the demutualization will not be stockholders of the Exchange.

b. Dividend Rights

Because the Series A Preferred Stock will be issued only to enable the non-stockholder Member Organizations to vote indirectly for the On-Floor Governors, Article FOURTH (a)(i) of the proposed Certificate of Incorporation will provide that the Series A Preferred Stock will not have the right to receive any dividends.

c. Liquidation Preferences

Pursuant to Article FOURTH (a)(ii) of the proposed Certificate of Incorporation, upon liquidation of the Phlx the holder of the share of Series A Preferred Stock will be entitled to receive an amount equal to the par value of the share of Series A Preferred Stock (or $0.01) held by the holder after the payment of, or provision for, obligations of the Phlx and any preferential amounts payable to holders of any other class or series of outstanding shares of preferred stock.

d. Transferability

Article FOURTH (a)(iv) of the proposed Certificate of Incorporation will provide that the Series A Preferred Stock will not be transferable (whether by sale, pledge, operation of law or any other disposition) without the prior written consent of the Board. If the Board determines that it is in the best interests of the Exchange or its stockholders for any holder of the share of Series A Preferred Stock to sell the share to the Exchange or any other person, the holder will be required under Article FOURTH (a)(iii) of the proposed Certificate of Incorporation to effect the sale as directed by the Board.[26]

[25] 15 U.S.C. 78c(a)(3)(A).

[26] Any proposal to sell the Series A Preferred Stock would have to be filed with the Commission pursuant to Section 19(b) of the Act.

B. Corporate Governance of the Demutualized Phlx

According to Article SIXTH of the proposed Certificate of Incorporation and Sections 4–1 and 4–4 of the proposed By-laws, the principal management of the Phlx after demutualization will continue to rest with the Board and the Standing Committees of the Exchange. To ensure compliance with the Act in the context of a demutualized Exchange, Article SIXTH of the proposed Certificate of Incorporation will provide that, in managing the business and affairs of the Phlx, the Governors will have to consider applicable requirements for registration as a national securities exchange under Section 6(b) of the Act,[27] including the requirements that: (i) the rules of the Phlx be designed to protect investors and the public interest, and (ii) the Phlx be so organized and have the capacity to carry out the purposes of the Act and (except as otherwise provided in the Act or the rules and regulations thereunder) to enforce compliance by its Members and persons associated with its Members with the Act, the rules and regulations thereunder, and the rules of the Phlx.

1. Board of Governors—Composition; Eligibility

Article SIXTH of the proposed Certificate of Incorporation, together with Section 4 of the proposed By-laws, will set forth the required number and composition of the Board. Pursuant to Section 4–1 of the proposed By-laws, the composition of the Board will be the same as before the demutualization and, as set forth in Section 4–3(b) of the proposed By-laws, will consist initially of the same individuals in office at the time of the demutualization. According to Article SIXTH (a) of the proposed Certificate of Incorporation, the Board will continue to have a total of 22 Governors and be composed as follows:

- the Chairman of the Board, who will be the individual then holding the office of Chief Executive Officer (''CEO'');
- 11 Non-Industry Governors (of whom at least five will have to be public Governors); and
- 10 Industry Governors (of whom five will have to be On-Floor Governors and five will have to be Off-Floor Governors).

The criteria set forth in the Exchange's current By-laws for eligibility of persons to serve as a Governor within each category of Governor will remain the same after demutualization.

[27] 15 U.S.C. 78s(b).

2. Board of Governors—Classification and Term Limits

According to Section 4–3(a) of the proposed By-laws, the Board will remain classified, with Governors serving staggered three-year terms. Governors (other than the Chairman) may serve for up to two consecutive three-year terms starting from the effective time of the Merger. In order to preserve continuity post-demutualization, Section 4–3(b) of the proposed By-laws will provide that Governors who hold their positions at the effective time of the Merger will continue to hold those positions, in their respective classes, until their original terms expire and that the term limits will not take into consideration any service as Governor before the demutualization but will only apply from and after the effective time of the Merger. The Exchange believes that this provision serves to ensure continuity in the governing body of the Exchange through such a significant corporate event as the demutualization.

3. Nomination and Election of Governors

According to the Phlx, the Exchange's nomination and election procedures are revised to ensure continuing fair representation for Members and Member Organizations in the context of the demutualized Exchange, while at the same time adapting the Exchange to its proposed status as a demutualized business corporation with stockholders. Generally, the new nomination and election structure of the Exchange will be as follows:

- The Non-Industry Governors, Off-Floor Governors and the Chairman of the Board will continue to be nominated by the Nominating and Elections Committee and will be elected by the holders of the Common Stock at meetings of stockholders.
- Stockholders will be permitted to make independent nominations of Non-Industry and Off-Floor Governors upon written notice of the nominations not less than 90 nor more than 120 days before the first Monday in February of each year (or such other date as the Board may establish). These nominations will be subject to review by the Nominating and Elections Committee.

Member Organizations, as described below, will designate the On-Floor Governors in accordance with the following procedures:

- On-Floor Governors will be nominated by the Nominating and Elections Committee from recommendations made: (i) By members

of the Nominating and Elections Committee; or (ii) by any Member, participant or Member Organization Representative.

• Independent nominations by Member Organization Representatives will be valid only if signed by Member Organization Representatives representing no less than 50 votes.

• Member Organizations, through their authorized Member Organization Representative, will vote for designated On-Floor Governors among nominees so selected at the annual meeting of Members and Member Organizations.

• Nominees for Governors receiving the highest numbers of votes for the category of Governor for which they were respectively nominated as candidates will be declared the ''Designated Nominees'' for those offices. In case of a tie, the Nominating and Elections Committee will make the selection as to who among the tying nominees shall be designated.

• On-Floor Governors will then be elected by the Trust owning the share of Series A Preferred Stock based on the ''Designated Nominees'' elected by the Member Organization Representatives as described above.

4. Governors—Vacancies and Removal

In accordance with Section 3–8 of the proposed By-laws, vacancies (including vacancies created by increases in the size of the Board of Governors) will continue to be filled by the Nominating and Elections Committee, upon approval by a majority of the Governors. With respect to the removal of Governors, Article SIXTH (b) of the proposed Certificate of Incorporation and Sections 3–3 and 4–4 of the proposed By-laws will provide that Governors may be removed only for cause or, under certain circumstances, upon recommendation by a majority of the Board of Governors. In addition, Governors may be removed only by a 66⅔% vote of the group that elected them (*i.e.*, the holders of common stock, in the case of the Non-Industry or Off-Floor Governors, or the share of Series A Preferred Stock as instructed by a vote of the Member Organization Representatives, in the case of the On-Floor Governors).

An On-Floor Governor may be removed at any annual or special meeting. A special meeting for the removal of an On-Floor Governor may be called by the Chairman of the Board of Governors or the Board of Governors or, only in the case of a special meeting of Member Organization Representatives for the purpose of voting on the removal of an On-Floor Governor, by the Member Organization Representatives representing a majority of the then issued and outstanding permits. If such a meeting is proposed to be called by Member Organization Representatives, such Member Organization Representatives must provide the Chairman written notice prior to calling any such meeting stating in reasonable detail the basis for, and the facts and circumstances purported to warrant, such removal of the relevant On-Floor Governor.

5. Committees

No changes will be made in Board committee structure or composition as part of the demutualization process, except as follows:

• pursuant to Sections 10–6 and 10–17 of the proposed By-laws, respectively, at least half of the Admissions Committee and the Foreign Currency Options Committee, respectively, will have to be Members, participants or persons affiliated with Member Organizations or participant organizations;

• pursuant to Sections 10–20 and 10–16 of the proposed By-laws, respectively, at least half of the Options Committee and the Floor Procedure Committee, respectively, will have to be Members or persons affiliated with Member Organizations;

• pursuant to Section 10–6 of the proposed By-laws, the Business Conduct Committee will share with the Admissions Committee jurisdiction over the revocation of permits and foreign currency options participations in connection with disciplinary matters; and

• pursuant to Section 10–7(a) and (b) of the proposed By-laws, certain term limits applicable to members of the Allocations Committees will be eliminated.

The existing Certificate of Incorporation and By-laws do not include any specification as to the composition of the Admissions Committee, Foreign Currency Options Committee, the Options Committee or the Floor Procedure Committee and, therefore, do not require the committees to include any Industry Governors. Accordingly, the Phlx states that the proposed rule change will ensure participation of Industry Governors on each of these committees, thereby allowing Industry Governors to take part in decisions made in vital areas of day-to-day trading operations and membership matters. The elimination of term limits respecting the Allocations Committees is intended to achieve consistency with most other committees, which do not have such limits.

6. Management and Executive Officers

The management structure of the Exchange, including its executive officers, will remain unchanged in the demutualization in accordance with Article V of the proposed By-laws. The CEO position will continue to be a full-time position to be appointed by the Board, and the holder of this position will act as the Board's Chairman. The person acting as CEO at the time of the demutualization will be the only nominee for the position of Chairman of the Board, and will be elected by the votes of the holders of the Common Stock. The existing requirement that the CEO may not be a partner of a Member (or participant) Organization, nor an employee, agent, consultant, officer, director or stockholder of a Member (or participant) Organization will be retained. The CEO will appoint the other officers of the Exchange.

7. Limitation of Liability and Indemnification

Articles FIFTEENTH and SIXTEENTH of the proposed Certificate of Incorporation and Section 4–18 of the proposed By-laws will include provisions substantially similar to the Article EIGHTEENTH of the existing Certificate of Incorporation, in accordance with Section 145 of the Delaware General Corporation Law. Such provisions eliminate the personal liability of Governors (and other persons mentioned below) for monetary damages for breach of fiduciary duty as a Governor, except for liability:

• for any breach of the Governor's duty of loyalty to the Phlx or its stockholders;

• for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law;

• under Section 174 of the Delaware General Corporation Law regarding unlawful dividends and stock purchases; or

• for any transaction from which the Governor obtained an improper personal benefit.

The proposed Certificate of Incorporation and By-laws will further permit the Phlx to indemnify to the fullest extent permitted under and in accordance with the laws of the State of Delaware any Governor (or director) or officer of the Phlx, and any person that is or was serving at the request of the Phlx as a Governor, committee member or in-house legal counsel, officer, director (or person in similar position), employee or agent of another corporation or of a partnership (general or limited), limited liability company,

joint venture, trust or other enterprise or business entity, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person in connection with any action, suit or proceeding if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the Phlx, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful. The Phlx may also pay the expenses of indemnified persons incurred in defending a suit or proceeding in advance of the final disposition of the suit or proceeding. The proposed Certificate of Incorporation will also permit the Phlx to secure insurance on behalf of any officer, director, employee or other agent for any liability arising out of his or her actions in that capacity. The Exchange believes that these indemnification provisions are substantially similar to those generally employed by other Delaware stock corporations and the scope of the persons covered is intended to continue to attract and retain qualified personnel.

C. Members and Member Organizations

1. Member Organizations and Member Organization Representatives

As under the current structure, a Member will continue to be permitted to be associated with more than one Member Organization.[28] In accordance with proposed Rule 908(c)(ii), each holder of a permit will be obliged, however, to designate only a single eligible organization with which the Member is associated as the Member's ''primary affiliation'' for the purposes of voting, as will be provided in Article III of the proposed By-laws. A Member will be allowed to qualify as a Member Organization only the entity the Member has designated as his or her primary affiliation. Accordingly, every Member shall have one primarily-affiliated Member Organization and may have more than one associated Member Organization.

Unlike the current Phlx regime, after demutualization, individual Members will not directly be accorded voting rights. Rather, in regard to the election and removal of On-Floor Governors, Member Organizations will be entitled to exercise voting rights in respect of the permits held by those Members who have designated the Member Organization as their primary affiliation. Specifically, pursuant to proposed Rule 921 and Section 12–8 of the proposed By-laws, each Member Organization will have to register with the Exchange and designate a single individual as its ''Member Organization Representative.'' The concept of a Member Organization Representative is designed to facilitate the post-demutualization voting process. Permit holders, or Members, themselves will not exercise any voting rights. Instead, voting rights associated with a permit will be exercised by the Member Organization with which the Member is primarily associated and, as noted above, will be exercised by the Member Organization's Member Organization Representative. The Member Organization Representative will be the only person who may exercise the voting rights in respect of the Member Organization in respect of matters on which Member Organizations may vote. Proposed Rule 921 also will provide that a Member Organization Representative will have to accept the designation by filling out a registration documentation required by the Exchange.

Pursuant to proposed Rules 921 and 972, with the exception of certain provisions in proposed Rule 921(c) retaining the existing concept of ''inactive nominees'' in order to alleviate hardships, failure to qualify a Member Organization Representative at any time will prevent a Member Organization from exercising any rights in connection with the Exchange, including the right to vote for designated On-Floor Governors as described below.

According to proposed Rule 924, Members[29] will be liable with respect to any fees, fines, dues, penalties or other amounts imposed by the Exchange in connection with such Member's permit or any activities conducted in connection with such permit, whether or not any such obligation was incurred on behalf of his account or on behalf of his Member Organization. In addition, proposed Rule 924 will provide that Member Organizations will be liable with respect to any fees, fines, dues, penalties or other amounts imposed by the Exchange in connection with such Member Organization and any Member associated with such Member Organization in connection with a permit or any activities conducted in connection with such permit by such Member on behalf or for the account of such Member Organization. Under proposed Rule 924(b), similar to the rule in effect today, Member Organizations will have the ability to allocate responsibilities among themselves regarding Members associated with more than one Member Organization, provided that any such arrangements have been provided to the Exchange in the form required by it at least 30 days prior to their desired effectiveness.

2. Voting Rights

After the demutualization, holders of permits will not have any voting rights. Member Organizations will have the right to:

- designate the five On-Floor Governors for election to the Board in accordance with Section 3–12 of the proposed By-laws;
- remove the On-Floor Governors in accordance with Sections 3–2(c) and 3–3 of the proposed By-laws (together with the right to designate the On-Floor Governors, the ''Designation Rights''); and
- designate the On-Floor Vice-Chair in a contested election as described below.

Each permit will carry one vote. As discussed above, the vote may be exercised only by the qualified Member Organization Representative of a Member Organization designated by a holder of a permit as its primary affiliation.

The Designation Rights will be exercised in accordance with the following procedure:

- based on input from the membership or others, the Nominating and Elections Committee will propose a slate of qualified On-Floor Governors;
- in addition, the Member Organization Representatives, representing at least 50 permits, will be permitted to propose qualified alternative candidates;
- the Member Organization Representatives, at an annual meeting of Members and Member Organizations, will then elect the designated On-Floor Governors from among the Nominating and Elections Committee's slate and any qualified individuals nominated by Member Organization Representatives in accordance with the nomination procedures.

The winners of this election will then be eligible for designation as On-Floor Governors. In compliance with Delaware corporate law, the designated On-Floor Governors will be formally elected by the Trust that holds the single outstanding share of Series A Preferred Stock in accordance with Article FOURTH (a)(iii) of the proposed Certificate of Incorporation.

[28] *See* Phlx Rule 793.

[29] This rule also applies to FCO participants and participant organizations with respect to FCO participations.

3. Contested Election of the On-Floor Vice Chairman

With respect to the election of the On-Floor Vice Chairman, Section 4–2 of proposed By-laws will provide that, if there is a contest for the position of On-Floor Vice Chairman of the Board, the On-Floor Vice Chairman of the Board may be selected from the On-Floor Governors by a vote of the Member Organization Representatives, as promptly as possible after the annual meeting of stockholders at a special meeting of Members and Member Organizations called for that purpose.

4. Voting Concentration Limits

In order to prevent any group of Members of Member Organizations from dominating elections of the Member Organization Representatives, the proposed By-laws will provide in Section 3–12(c) that if any Member Organization, directly or indirectly, possesses the right to vote more than 20% of the then outstanding permits, that Member Organization will not have any right to vote, or to give any consent or proxy with respect to, any permits exceeding the 20% (''Excess Permits''), and the Excess Permits will not be considered present for the purposes of determining whether a quorum is present at any meeting or vote of the Members or Member Organizations, and will not be entitled to vote in determining the number of permits required for a quorum or to be voted for approval of or to give consent with respect to any matter presented to the Members or the Member Organizations.

5. Member and Member Organization Meetings and Actions

Pursuant to Section 3–2 of the proposed By-laws, annual meetings of Members and Member Organizations will be held on the second Monday in March of each year to designate nominees for On-Floor Governors. Except with respect to a special meeting called for the purpose of removing an On-Floor Governor, special meetings of Members or the Member Organization Representatives may be called at any time only by the Chairman of the Board or by a majority of the Board.

At all meetings of Members and Member Organizations, each Member Organization Representative may cast his or her vote in person or by proxy, provided that no action will become effective unless there shall have been voted a majority of the number of permits outstanding at such time, not including any Excess Permits. Each Member Organization Representative may cast the number of votes equal to the number of permits held by Members having designated the Member Organization Representative's Member Organization as its primary affiliation (subject to the voting restrictions described above).

Section 3–11 of the proposed By-laws will provide that notice of any meeting of Members and Member Organizations must be given to each Member Organization Representative entitled to vote at such meeting not less than 10 days nor more than 50 days before the date of the meeting.

6. Disciplinary Actions and Appeal Process

The Exchange states that enforcement of any disciplinary action and appeals of any disciplinary action will be conducted in the same manner as before the demutualization.

D. Permits and Trading Rights

1. Issuance of Permits and Application Process

Under the proposed Plan of Demutualization, access to the Exchange facilities and the right to trade will be conferred by the newly-issued permits rather than by ownership or leasing of Seats of the Exchange. As discussed above, trading of foreign currency options will continue to be allowed through the existing FCO participations, but, following the demutualization, will also be permitted through permits, as will be provided in proposed Rule 908(c)(i).

Proposed Rule 971 will provide that all ETPs and ETP use agreements will terminate with immediate effect as of the close of trading on the day the Merger becomes effective without any further action on the part of any party thereto. Similarly, proposed Rule 971 will also provide that all leases of Seats and all leases and A–B–C agreements with respect to such Seats, will terminate with immediate effect as of the close of trading on the day the Merger becomes effective without any further action on the part of any party thereto. All provisions in the Certificate of Incorporation, By-laws and Rules relating to the transfer or lease of a Seat or A–B–C agreement, and all defined terms related thereto (such as ''Lessor'' and ''Lessee'') will be amended as necessary to reflect that, after the demutualization, these provisions and defined terms will only apply to FCO participations. These provisions will no longer be applicable to permits, because permits (including the Series A–1 Permits) will not constitute property that can be transferred by its holder (except within the same member Organization). Similarly, the provisions relating to ETPs, such as Rule 23, will be deleted.

To provide an orderly transition from Seats to permits, proposed Rule 972 will allow each Member (including, without limitation, each holder of an ETP), inactive nominee and Member Organization holding that status immediately before the effective time of the Merger that, at that time, is not subject to any suspension of that status, to maintain that status. All Members and ETP holders who fulfill the requirements described in the previous sentence will receive Series A–1 Permits immediately upon the demutualization.

Proposed Rule 972 will also provide that existing Member Organizations will maintain their status for a period of 15 days following the Merger. Each Member Organization, however, will have to provide to the Admissions Committee and the Exchange, as applicable, before the end of the 15-day period, the following:

- the security deposit or alternative compliance with proposed Rule 909 (the ''security requirement'') (as described below);
- the form to be filed by the Member Organization's qualifying permit holder; and
- the designation of the Member Organization's Member Organization Representative in the form prescribed by the Exchange.

If a Member Organization fails within that period to comply with the security requirement and/or to furnish the form to be filed by the Member Organization's qualifying Member, the Member Organization's status as such will immediately be suspended. If a Member Organization fails to designate a Member Organization Representative, the Member Organization may not exercise any voting rights with respect to any permits held by persons who are associated with the Member Organization.

2. Classes or Series of Trading Permits

Immediately after the demutualization, pursuant to Section 12–1 of the proposed By-laws and proposed Rule 908, there will be only one series of permit, called the ''Series A–1 Permit,'' which will confer upon its holder all the rights and privileges of a Member of the Exchange. An individual will be allowed to hold a Series A–1 Permit if he or she meets the qualification criteria that will be set forth in Article XII of the proposed By-laws and Rules 901 and 908 and/or may be imposed by the Admissions Committee (which criteria the Exchange intends will remain largely the same as

they were before the demutualization), including the requirements that a Member be an individual at least 21 years of age and be associated with a Member Organization.[30] Pursuant to Sections 12–1 and 12–4 of the proposed By-laws and proposed Rule 908(b), Series A–1 Permits will be limited or unlimited in number and may be issued from time to time by the Exchange, as determined by the Board in its sole discretion.

After demutualization, Section 12–1 of the proposed By-laws will empower the Board to:

- authorize the issuance of an unlimited or restricted number of additional permits;
- terminate or eliminate any class or series of permits; and
- create additional classes or series of permits.

The Exchange represents that any of these actions will continue to be subject to Commission review and/or approval. In accordance with Section 12–3 of the proposed By-laws, no person will be allowed to hold more than one permit.

3. Qualifications

Initially, except to the extent provided in applicable product and/or activity criteria set forth in the proposed Rules, qualifications and other requirements for Members to conduct certain activities (*e.g.*, to act as a specialist or a floor broker), to trade certain products (*e.g.*, special capital requirements for specialists for certain equity securities, allocation of books and Registered Options Trader assignments) or to use specific facilities of the Exchange (*e.g.*, testing requirements for use of certain Exchange technology) will remain largely the same as they were before the demutualization.

4. Security Requirement

According to proposed Rule 909, each Member Organization will have to provide to, and maintain security with, the Exchange (or alternative compliance) for the payment of any claims owed to the Exchange, to SCCP, and to Members and/or other Member Organizations. Currently, Section 14–5 of the By-laws provides that the Exchange (through the Admissions Committee) may dispose of any Seat upon written notice if amounts owed to the Exchange exceed a certain threshold amount and have been outstanding for at least one year. This possibility will be eliminated in connection with the elimination of Seats in the demutualization. Accordingly, the Exchange proposes the security requirement to protect itself in the case of non-payment of certain amounts owed. The proposed security requirement will consist of:

(i) excess net capital of at least the amount required by the Exchange, as will be published by the Exchange from time to time; [31]

(ii) an acceptable guaranty by a clearing Member Organization that is acceptable to the Exchange; or

(iii) a deposit with the Exchange in an amount not to exceed $50,000.

The amount of the security for a Member Organization will remain the same regardless of the number of permits issued to affiliates of the Member Organization. If a Member Organization's registration is terminated and no Members remain associated with the Member Organization, the Exchange will be permitted to apply the proceeds of any remaining security to the payment of any amounts owed by or on behalf of the Member Organization to, or claimed by, the Exchange, to SCCP, and to other Member Organizations, and any balance of the security thereafter remaining will be returned to the Member Organization or, in the case of a guaranty, the guaranty will be returned to the guarantor Member Organization.

The proposed By-laws will also provide in Section 12–9(b) that following the demutualization, Members, Member Organizations and holders of FCO participations will have to pledge in writing to abide by the proposed Certificate of Incorporation, the proposed By-laws, the proposed Rules and any other rules and regulations of the Exchange.

5. Term and Termination of Permits

Pursuant to proposed Rule 908(e), the holder of a permit will be allowed to terminate the permit at any time upon written notice to the Exchange. The Exchange will be allowed to terminate any individual permit in accordance with the By-laws and Rules of the Exchange only upon:

- the non-payment of any dues, foreign currency options users' fees, fees, fines, penalties, other charges, and/or other monies due and owed the Exchange;
- the insolvency of a Member or Member Organization (or if the Business Conduct Committee has determined the Member or Member Organization to be financially unsafe to continue trading); or
- the Exchange's imposition of a disciplinary sanction.

The terminating permit holder and each Member Organization with which the holder is associated will remain responsible for all obligations of the terminating Member, including, without limitation, all applicable dues, fees, charges, fines, penalties and other obligations arising from the holding or use of a permit before its termination.

Pursuant to proposed Rule 908(f), the Exchange will be able to terminate the entire series of Series A–1 Permits on no less than 60 days' notice to the permit holders.[32] If, however, within six months after any such termination of the entire series of Series A–1 Permits, the Exchange issues any other class or series of permit with respect to any securities product previously covered by the Series A–1 Permit, any permit holder of a terminated Series A–1 Permit, who meets the applicable eligibility requirements with respect to such new class or series of permit, will be entitled to receive on terms no less favorable than those applicable to other persons such new class or series of permit so long as such permit holder will trade with such new class or series of permit such product in the same capacity as he had done with a Series A–1 Permit before such termination (but only if he had continuously traded such product in such capacity for at least one year prior to such termination). In addition, such holder of the terminated Series A–1 Permit will be required to apply for such new permit within 30 days of the later to occur of: (i) The termination of the series of Series A–1 Permits; or (ii) the initial issuance of the new class or series of permit.

6. Transfer of Permits

Section 12–1(b) of the proposed By-laws, as well as proposed Rule 908(h), will provide that, unless the Board resolves otherwise, no permit may be sold, transferred (by operation of law or otherwise), leased or otherwise encumbered by any person to whom such permit is issued by the Exchange. However, proposed Rule 908(h) provides that the existing concept of ''inactive nominees'' will be retained to alleviate certain administrative hardships for Member Organizations,

[30] Under Sections 12–2 and 12–4 of the proposed By-laws, Stock Clearing Corporation of Philadelphia (''SCCP''), as an eligible corporation, may hold a permit but will continue not to be subject to the qualification criteria applicable to persons seeking a permit. SCCP, a subsidiary of the Phlx, is a registered clearing agency.

[31] In accordance with the By-laws and Rules, the Member Organization will be subject to monthly reporting obligations to evidence the maintenance of that excess net capital requirement.

[32] As noted above, the Exchange represents that certain actions with respect to the permits, including termination of any class or series of permits will be subject to Commission review and approval.

such that a permit can be transferred to and from an inactive nominee.

E. Fees, Dues and Charges

Currently, the Board of Phlx has the authority to set fees, dues and other charges [33] in its sole discretion, subject to the requirements under the Act, including filing requirements. Pursuant to lease agreements, Members who lease Seats from Owners are ordinarily required to make lease payments in respect of the lease.

After the demutualization, the Board of the Phlx will continue to have the authority to set Member fees, dues and other charges in its sole discretion in accordance with Section 14–1 of the proposed By-laws. However, seat leases and lease payments (other than with respect to FCO participations) will no longer exist. All other Exchange charges in effect at the time of the demutualization will continue to apply until changed.[34] The Exchange notes that all fees are subject to change, both before and after demutualization, subject to approval by the Board and filing with the Commission.

In connection with the demutualization, the Exchange proposes to make certain corresponding changes to the defined terms applicable to its By-laws and Rules. These changes, reflected in Section 1–1 of the existing and the proposed By-laws, as well as in Rules 1 through 21 of the existing Rules and 1 through 22 of the proposed Rules, are generally designed to adapt such defined terms to the proposed post-demutualization structure of the Exchange, as described herein.

F. Summary of Non-Demutualization-Related Changes

Certain aspects of the proposed rule change are not directly related to the Plan of Demutualization. According to the Exchange, these changes are principally of a clean-up nature and are intended to delete obsolete provisions that relate mainly to membership, to provide clarity and to avoid confusion following the demutualization.

1. Definition of Member Firm, Member Corporation and Member Organization

The Exchange proposes to harmonize the use of the defined terms Member Firm, Member Corporation and Member Organization throughout its By-laws and Rules by eliminating the separate defined terms ''Member Firm'' (Rule 3 of the existing Rules) and ''Member Corporation'' (Rule 4 of the existing Rules) and amending the defined term ''Member Organization'' (Rule 6 of the existing Rules and Rule 3 of the proposed Rules) to include any Member Firm and Member Corporation, as they were previously defined. Wherever such defined terms appear in either the By-laws or the Rules, the Exchange proposes to make the corresponding change to Member Organization. The Exchange believes that these changes eliminate certain definitional inconsistencies.

2. Convertible Memberships

The Exchange proposes to delete the parts of Article XII of the existing By-laws that relate to ''convertible memberships'' on the Exchange, together with any references to any classes of memberships that existed in connection with the Exchange's pre-1975 status as an unincorporated entity. No such convertible membership has been outstanding at any time and any transitional rules relating to the Exchange's previous unincorporated status are obviously no longer required.

3. Commissions

The Exchange proposes to delete Article XIX of the existing By-laws in its entirety, which relates to certain requirements for fixed rates of commissions for transactions effected on or by the use of the facilities of the Exchange. The Exchange believes these provisions do not comport with Section 6(e) of the Act.[35] To avoid confusion, the Phlx proposes that these provisions be deleted without replacement. The Exchange also proposes to delete related Rule 248.

4. Market-Maker Membership

The Exchange proposes to delete Article XXIII of the existing By-laws, relating to Market-Maker Memberships, in its entirety. The Phlx advises that no such Market-Maker Membership has been issued since the 1970s and none is currently outstanding. Following the demutualization, the Exchange is not initially proposing to create a specific permit for market-makers; any rights and privileges required to engage in market making on the Exchange initially will be granted through the proposed Series A–1 Permit. The Exchange also proposes to delete related Rules 456–459. The Phlx advises that these deletions are intended to avoid confusion with respect to these unused membership-related provisions.

5. Exchange Options Trading

The Exchange proposes to delete Article XXVI of the existing By-laws, relating to Exchange options trading through a classification of membership named ''Options Membership'' in its entirety. The Phlx states that no such Options Membership has at any time been issued and outstanding. Following the demutualization, the Exchange will not initially create a specific permit to trade options on the Exchange; any rights and privileges required to engage in trading options on the Exchange initially will be granted through the proposed Series A–1 Permit. Accordingly, this deletion is also intended to avoid confusion.

6. References to the Exchange's Constitution

The Exchange proposes to delete references to the ''Constitution of the Exchange'' from the Rules 111, 201A and 960.2, as well as from the Commentary to Rule 803. Where applicable, the references will be either deleted in their entirety or will be replaced by references to the Certificate of Incorporation. The Exchange advises that it has not had a Constitution since its incorporation in 1972 and, since that time, has been governed exclusively by its Certificate of Incorporation and By-laws.

7. References to the Exchange's President

The Exchange proposes to delete references to the Exchange's ''President'' from the Rules and replace such references with ''Chairman of the Board of Governors.'' The Exchange indicates that it has not established the position of a President and has no immediate plans to establish such a position after the demutualization.

8. Participation in Mandatory Decimalization Testing

The Exchange proposes to delete Rule 650 in its entirety, which relates to the mandatory participation of Members in certain programs concerning the testing of the Exchange's system in connection with decimalization. According to the Phlx, such tests have been performed, and, therefore, Rule 650 has become obsolete.

III. Summary of Comments

The Commission received one comment letter in response to the

[33] According to the Exchange, the existing and proposed By-laws and Rules may refer to ''dues, fees and other charges'' to cover various types of monies owed to the Exchange; however, no substantive difference is intended.

[34] Separately, with the elimination of Seats and leases thereof, the Exchange filed a proposed rule change pursuant to Section 19(b) of the Act to adopt fees applicable to Series A–1 Permits and to make conforming changes to its fee schedule as a result of the demutualization. *See supra* note 11.

[35] 15 U.S.C. 78f(e).

proposed rule change.[36] The Penn Mont Letter stated that the Plan of Demutualization was flawed for two reasons. First, the letter noted that, after the demutualization, members no longer would have the ability to propose and vote on rulemaking initiatives. Second, the Penn Mont Letter stated that, in light of the Commission's recent approval of the two-board structure for the New York Stock Exchange, Inc. (''NYSE''), the Phlx should adopt the same structure for its Board of Governors.

In responding to the Penn Mont Letter, the Exchange noted that the reason for eliminating Members' right to petition with respect to changes to the By-laws is that Delaware law requires that stockholders amend the By-laws.[37] The Phlx pointed out that Members will continue to have the same voice in rulemaking at the Exchange through the various committees of the Board of Governors. Specifically, the Phlx noted that Members, either by serving on such committees or by contacting committee members, can raise issues for discussion or rules for adoption. The Exchange noted that, in connection with the demutualization, it proposed to increase member involvement on several committees and that, in its view, the current and proposed committee structure and the Exchange's governance structure are consistent with the fair representation requirements of Section 6(b)(3) of the Act.[38]

Regarding the Penn Mont Letter's recommendation that the Phlx adopt the same dual-board structure that was recently approved for the NYSE, the Exchange noted its belief that at this time the governance structure proposed in its filing is consistent with the Act and the structures of other SROs and is appropriate on a going forward basis. The Exchange stated that both the NYSE's governance specifically and the governance structure of SROs in general are important policy issues, separate from the Exchange's immediate plan to demutualize. The Phlx noted that it would be unfair to delay its efforts to demutualize for this reason alone because the Exchange can and should continue to evaluate its governance structure in the future.

IV. 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.[39] In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(1) of the Act,[40] which requires a national securities exchange to be so organized and have the capacity to carry out the purposes of the Act and to enforce compliance by its members and persons associated with its members with the provisions of the Act. The Commission also finds that the proposed rule change is consistent with Section 6(b)(3) of the Act, which requires that the rules of a national securities exchange assure the fair representation of its members in the selection of its directors and administration of its affairs, and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer. Further, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,[41] in that it is designed, among other things, to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest.

A. Changes in Control of the Phlx

The proposed Certificate of Incorporation imposes limitations on direct and indirect changes in control of the Phlx through voting and ownership limitations placed on the Common Stock, and monitors potential changes in control through a notification requirement, once a threshold percentage of ownership of the Common Stock is reached. The Commission believes that the limitations on direct and indirect changes in control of the Phlx are sufficient to enable the Phlx to carry out its self-regulatory responsibilities, and to enable the Commission to fulfill its responsibilities under the Act.[42]

The proposed Certificate of Incorporation provides that, unless approved by the Board and effective under Section 19(b) of the Act, no Person, either alone or together with its Related Persons, has any right to vote, or to give any consent or proxy with respect to, more than 20% of the then outstanding shares of Common Stock (any shares of Common Stock owned in excess of 20% are referred to as ''Excess Shares''). In addition, such Excess Shares will be deemed not to be present for the purposes of determining whether a quorum is present at any meeting or vote of the stockholders of the Exchange.[43]

Moreover, no Person (either alone or together with its Related Persons, unless approved by the Board and effective under Section 19(b) of the Act) may own, of record or beneficially, whether directly or indirectly, more than 40% of the then outstanding shares of Common Stock of the Phlx. To the extent that such Person (or its Related Persons) purports to own more than 40% of the then outstanding shares of Common Stock, the Person (and its Related Persons) will not be entitled to exercise any rights and privileges incident to ownership of shares in excess of the 40% limit.[44] Finally, the Exchange has the right, but not the obligation, to purchase the shares in excess of the 40% threshold for a price equal to the par value of the Common Stock.

Article FOURTH of the Phlx Certificate of Incorporation will require the Board to approve a By-law amendment to permit any Person, together with its Related Persons, to exercise voting rights with respect to their excess shares or to own more than 40% of the outstanding shares. This amendment to the By-laws would have to be filed with the Commission pursuant to Section 19(b) of the Act. The proposed rule change would present the Commission with an opportunity to determine what additional measures, if any, might be necessary to provide sufficient regulatory jurisdiction over the proposed controlling persons.

The proposed Certificate of Incorporation provides that no Member (either alone or together with its Related Persons) will be allowed to own, of record or beneficially, whether directly or indirectly, more than 20% of the then outstanding shares of Common Stock of the Phlx.[45] To the extent any Member (or its Related Persons) purports to own more than 20% of the then outstanding shares of Common Stock, that Member (and its Related Persons) will not be allowed to exercise any of the rights or

[36] *See* Penn Mont Letter, *infra* note 7.

[37] Letter from Edith Hallahan, Deputy General Counsel, Phlx, to Nancy Sanow, Assistant Director, Division, Commission, dated January 11, 2004.

[38] 15 U.S.C. 78f(b)(3).

[39] 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).

[40] 15 U.S.C. 78f(b).

[41] 15 U.S.C. 78f(b)(5).

[42] The Commission has not formally established the standards for control persons of shareholder-owned national securities exchanges. It expects, however, to consider providing guidance on this issue in the future.

[43] Phlx Certificate of Incorporate, Article FOURTH, paragraph (b)(iii)(B).

[44] Phlx Certificate of Incorporation, Article FOURTH, paragraph (b)(v)(A).

[45] Phlx Certificate of Incorporation, Article FOURTH, paragraph (b)(v)(B).

privileges incident to the ownership of shares of Common Stock with respect to the shares exceeding the 20% limit. If any Member exceeds the 20% threshold, the Phlx will have the right, but not the obligation, to purchase from that Person and its Related Persons either the shares of Common Stock that exceed the 20% threshold for a price equal to the par value of the shares of such Common Stock.

The Commission finds that the limitation on member ownership is consistent with the Act. Today, a member who trades on an exchange can have an ownership interest in the exchange. However, a member's interest could become so large as to cast doubt on whether the exchange can fairly and objectively exercise its self-regulatory responsibilities with respect to that member. A member that also is a controlling shareholder of an exchange might be tempted to exercise that controlling influence by directing the exchange to refrain from diligently surveiling the member's conduct or from punishing any conduct that violates the rules of the exchange or the federal securities laws. An exchange also might be reluctant to surveil and enforce its rules zealously against a member that the exchange relies on as its largest source of capital.

The proposed Certificate of Incorporation requires any Person (either alone or together with its Related Persons) that at any time owns (whether by acquisition or by a change in the number of shares outstanding) of record or beneficially, directly or indirectly, 5% or more of the then outstanding shares of the Common Stock to immediately give the Board of Governors written notice of that ownership and update the notice promptly after an ownership change of a specified percentage.[46] The Commission believes that this approach is consistent with the Act in that it allows the Phlx to comply with the reporting requirements of Form 1, the application for (and amendments to application for) registration as a national securities exchange. Exhibit K of Form 1 requires any exchange that is a corporation or partnership to list any persons that have an ownership interest of 5% or more in the exchange; and Rule 6a–2(a)(2) under the Act requires an exchange to update its Form 1 within ten days after any action that renders inaccurate the information previously filed in Exhibit K.[47] Exhibit K imposes no obligation on an exchange to report parties whose ownership interests in the exchange is less than 5%. Similarly, the proposed Certificate of Incorporation requires the Phlx to monitor changes in its ownership structure only when a Person acquires an interest that equals or exceeds 5%.[48]

B. Fair Representation

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.

Under the proposed Certificate of Incorporation, the Exchange will continue to have a total of 22 Governors and will be composed of 11 Non-Industry Governors (of whom at least five must be Public Governors); 10 Industry Governors (of whom five must be On-Floor Governors and five must be Off-Floor Governors); and the Chairman of the Board, who will be the individual then holding the office of CEO. The Non-Industry Governors, Off-Floor Governors, and the Chairman of the Board will continue to be nominated by the Nominating and Elections Committee and will be elected by the holders of the Common Stock. On-Floor Governors will be nominated by the Nominating and Elections Committee from recommendations made by members of that committee or by any Member, participant, or Member Organization Representative. Also, independent nominations by Member Organization Representatives will be valid if signed by Member Organization Representatives representing no less than 50 votes. Member Organizations, through their authorized Member Organization Representative, will vote for designated On-Floor Governors among nominees selected at the annual meeting of Member and Member Organizations. The nominees for On-Floor Governors who received the highest number of votes will be the Designated Nominees, who will then be elected by the Trust owning the share of Series A Preferred Stock

In addition, pursuant to the proposed By-laws, at least half of the Admissions Committee and the Foreign Currency Options Committee will have to be Members, participants or persons affiliated with Member Organizations and at least half of the Options Committee and the Floor Procedure Committee will have to be Members or persons affiliated with Member Organizations. Further, the proposed By-laws require that the Business Conduct Committee share jurisdiction over the revocation of permits and foreign currency options participations in connection with disciplinary matters with the Admissions Committee. The Commission finds that the selection of the five On-Floor Governors out of a total of 22 Governors of the Phlx Board and the manner in which such Governors will be nominated and elected, together with the representation of members on key committees, satisfies the fair representation requirements in Section 6(b)(3) of the Act.[49]

The Commission notes that the proposal does not require that holders of foreign currency options (''FCO'') participations expressly be represented on the committees or on the Board of Governors, although representation on various committees and on the Board as On-Floor Governors is open to them. According to the Phlx, members holding solely FCO participations represent a *de minimis* amount of the membership and most Members that trade foreign currency options also hold regular memberships. In addition, the Phlx will retain its Foreign Currency Options Committee, of which at least 50% of its members must be permit holders or participants or be associated with a member or participant organization. In light of these provisions and the small number of FCO participants currently at the Exchange, the Commission believes that the provisions relating to FCO participations are consistent with the fair representation requirements of the Act. The Commission also finds that the requirement that the Board be composed of 11 Non-Industry Governors, of whom at least five must be Public Governors, is consistent with Section 6(b)(3) of the Act, which requires that one or more directors be representative of issuers and investors.

The Commission also notes that the proposed Certificate of Incorporation expressly requires the Governors, in managing the business and affairs of the Phlx, to consider applicable requirements for registration as a national securities exchange under Section 6(b) of the Act, including the requirements that the rules of the Phlx be designed to protect investors and the public interest and the Phlx shall be so organized and have the capacity to carry

[46] Phlx Certificate of Incorporation, Article FOURTH, paragraph (b)(iv) and (v).

[47] 17 CFR 240.6a–2(a)(2).

[48] The Commission notes, however, that the Exchange should disclose periodically, or otherwise make available upon request, information regarding the number of outstanding shares of Common Stock, so that persons with a stake in the Common Stock can determine whether they are reaching or have reached any of the thresholds that restrict that person's ability to vote or own the shares.

[49] 15 U.S.C. 78f(b)(3).

out the purposes of the Act and (subject to exceptions set forth in the Act and rules and regulations thereunder) to enforce compliance with its members and persons associated with its members, with the provisions of the Act and rules and regulations thereunder and with the Phlx's rules. In the Commission's view, this provision will serve to remind the Governors that they must consider the requirements of the Act when taking actions on behalf of the Phlx.

The Penn Mont Letter, the sole comment letter received by the Commission on the proposal, pointed to the Commission's recent approval of a dual-board governance structure for the NYSE [50] and urged that the Exchange amend its filing to take into account this new structure. The Commission notes that SROs, such as the Phlx, just recently have had the opportunity to review and assess the governance changes made by the NYSE in light of their own governance structures. Although the Exchange should be assessing its own governance structure in light of the recently-approved changes for the NYSE and in light of governance reforms recently approved for listed issuers,[51] the Commission believes that these issues can be addressed separately from the demutualization.[52]

Finally, the Penn Mont Letter stated that the Plan of Demutualization is flawed because members no longer will have the ability to propose independent rulemaking based on a vote of the membership. The Commission believes that the Phlx's response to this comment is persuasive, namely, that Delaware law requires that stockholders amend the By-laws. Moreover, as the Exchange points out, Members will retain a voice in Exchange rulemaking through participation on various Board Committees, some of which now will require at least half of the Committees' composition be Members or persons affiliated with Member Organizations.

C. Dividends

With the demutualization, the holders of Common Stock will have the dividend and other distribution rights of a stockholder in a Delaware stock corporation (except as may be limited by the rights any preferred stock may have, if any such stock is issued). The proposed By-laws, however, will prohibit the payment of dividends from any revenues received by the Exchange from regulatory fines, fees or penalties.[53] In the proposed rule change, the Phlx describes the methodology it will use to determine the amount of regulatory fines, fees and penalties that are subject to the dividend limitation, taking into account the amount of regulatory costs and expenses. The Commission finds that the prohibition on the use of regulatory fines, fees or penalties to fund dividends is consistent with Section 6(b)(3) of the Act because it will ensure that the regulatory authority of the Exchange is not used improperly to benefit the shareholders.

V. Accelerated Approval of Amendment No. 3

The Commission finds good cause exists for approving Amendment No. 3 to the proposed rule change prior to the thirtieth day after the amendment is published for comment in the **Federal Register**, pursuant to Section 19(b)(2) of the Act.[54] In Amendment No. 3, the Phlx formally submitted the Conversion Amendment as part of the proposed rule change in order to clarify that it is, in fact, a part of the proposed rule change. Also, the Phlx noted that the Conversion Amendment was briefly described in the proposed rule change and that it will be in effect just a very brief period of time prior to consummation of the Merger.

In the amendment, the Phlx also submitted copies of written comments received from market participants regarding the Plan of Demutualization after the Phlx had filed the proposed rule change with the Commission on November 17, 2003, and copies of the Exchange's responses to those comments.[55]

The Commission believes that acceleration of the amendment is appropriate. The Conversion Amendment was described in the Notice and the filing of its actual rule text presents no new issues.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 3, including whether the amendment is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments may also be submitted electronically at the following e-mail address: *rule-comments@sec.gov*. All comment letters should refer to File No. SR–Phlx–2003–73. This file number should be included on the subject line if e-mail is used. To help the Commission process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Phlx. All submissions should refer to refer to File No. SR–Phlx–2003–73, and should be submitted by February 17, 2004.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[56] that the proposed rule change (SR–PHLX–03–73), as amended, be and hereby is, approved, and Amendment No. 3 is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[57]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 04–1668 Filed 1–26–04; 8:45 am]

BILLING CODE 8010–01–P

[50] Securities Exchange Act Release No. 48946 (December 18, 2003), 68 FR 75012 (December 29, 2003).

[51] Securities Exchange Act Release No. 48745 (November 4, 2003), 68 FR 64154 (November 12, 2003).

[52] In March 2003, the Commission's Chairman sent a letter to the SROs, including the Phlx, asking that they review their own corporate governance practices in light of new listing standards for publicly traded companies. *See* Letter from William H. Donaldson, Chairman, Commission, to Meyer S. Frucher, Chairman and Chief Executive Officer, Phlx, dated March 26, 2003. In September 2003, the Commission's Chairman sent another letter to the SROs, including the Phlx, asking that they review the extent of public representation on their boards and key committees, decision-making processes relating to the nomination of directors and compensation of executives, and public disclosure of these processes and compensation arrangements. *See* Letter from William H. Donaldson, Chairman, Commission, to Meyer S. Frucher, Chairman and Chief Executive Officer, Phlx, dated September 23, 2003.

[53] Phlx By-Laws, Section 30–4.

[54] 15 U.S.C. 78s(b)(2).

[55] Instruction D to Form 19b–4 states that if, after the proposed rule change is filed but before the Commission takes final action, the SRO receives or prepares any correspondence or other communications reduced to writing (including any comment letters) to and from the SRO concerning the proposed rule change, copies of the communications must be filed in accordance with Instruction F to the form.

[56] 15 U.S.C. 78s(b)(2).