

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50892; File No. SR-CHX-2004-26]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 by the Chicago Stock Exchange, Inc. Relating to the Demutualization of the Chicago Stock Exchange, Inc.

December 20, 2004.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on November 24, 2004, the Chicago Stock Exchange, Inc. ("CHX" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the CHX. On December 15, 2004, the CHX filed Amendment No. 1 to the proposal.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The CHX proposes a series of changes to the CHX's corporate structure to allow for the demutualization of the CHX. To effect the demutualization, the CHX proposes to create a new Delaware for-profit stock holding company, CHX Holdings, Inc. ("CHX Holdings") that will become the parent company and sole shareholder of the CHX. The CHX will become a Delaware for-profit stock corporation that will continue to engage in the business of operating a national securities exchange registered under Section 6 of the Act.<sup>4</sup>

The proposed rule change for implementing the demutualization, including: (1) The CHX's revised rules; (2) the CHX's revised Certificate of Incorporation; (3) the CHX's revised Bylaws; (4) the Certificate of Incorporation for CHX Holdings; and (5) the Bylaws of CHX Holdings, are collectively referred to herein as the "proposed rule change" and are available for viewing on the Commission's Web site, <http://www.sec.gov>, and at the CHX and the Commission.

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

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

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

###### 1. Purpose

Through this submission, the Exchange proposes a series of changes to the Exchange's corporate structure that will allow for the demutualization of the Exchange.

###### a. Description of the Demutualization Transaction

The CHX proposes to demutualize by creating a new Delaware for-profit stock holding company, CHX Holdings, which will become the parent company of the CHX.<sup>5</sup> The CHX itself will become a Delaware for-profit stock corporation and will continue to engage in the business of operating a national securities exchange registered under Section 6 of the Act.<sup>6</sup>

On the effective date of the demutualization ("Effective Date"), each person or entity that owns a membership in the CHX will receive 1,000 shares of common stock of CHX Holdings for each membership that the person or entity owns, representing all of the issued and outstanding shares of CHX Holdings. Following the demutualization, persons and firms who have been qualified for membership under Articles 1, 2, or 3 of the Exchange's current rules and, as a

<sup>5</sup> In order to accomplish the demutualization, the CHX, which currently is a Delaware non-stock corporation, will establish two new Delaware stock for-profit corporations: CHX Holdings, a direct and wholly-owned subsidiary of the CHX; and CHX Merger Sub, Inc. ("CHX Merger Sub"), a direct and wholly-owned subsidiary of CHX Holdings. Pursuant to an agreement and plan of merger, CHX Merger Sub will merge with and into the CHX, with the CHX surviving the merger as a Delaware for-profit stock corporation that is a direct and wholly-owned subsidiary of CHX Holdings.

<sup>6</sup> 15 U.S.C. 78f. Following the demutualization, earnings of the CHX not retained in its business will be distributed to its parent, CHX Holdings, and CHX Holdings will be authorized to pay dividends to the stockholders of CHX Holdings as and when they are declared by the Board of Directors of CHX Holdings.

result, have access to the Exchange's trading floor and other facilities ("qualified trading members") will separately receive CHX trading permits entitling them to maintain the same trading access to the CHX that they currently enjoy.

Shares of CHX Holdings common stock and CHX trading permits will not be tied together. As a result, following the demutualization, former CHX members will be able to sell the shares of CHX Holdings common stock they receive in the demutualization, subject to the applicable restrictions described below, while still retaining any CHX trading permits that they were issued. Other persons who satisfy regulatory requirements will also be able to obtain CHX trading permits without regard to whether they are stockholders of CHX Holdings. Persons who hold CHX trading permits in the demutualized Exchange will be called "participants" or "participant firms."

###### b. Reasons for the Proposed Demutualization

There are several benefits that the Exchange believes may result from the demutualization of the Exchange. Perhaps the most important of these benefits is that the creation of CHX Holdings as a for-profit stock corporation may present opportunities to enter into strategic alliances involving the issuance of stock to its partners in such transactions. The Exchange believes that demutualization may increase the likelihood that these kinds of opportunities may be presented to the CHX, which could be beneficial to the stockholders of CHX Holdings.

The Exchange believes that another potential benefit to demutualizing is that converting the CHX from a not-for-profit corporation to a for-profit subsidiary of a for-profit holding company is likely to focus the business of the CHX more sharply on its profitability, which in turn should enhance the value of the Exchange to its owners. Additionally, by reorganizing the CHX into a holding company structure, there should be greater flexibility for the new holding company to acquire or expand into other businesses, as well as to dispose of certain business units if that should appear to be in the best interest of the enterprise and the stockholders of CHX Holdings.

The Exchange remains committed to its role as a national securities exchange and does not believe that a change to a for-profit institution will undermine its responsibilities for regulating its marketplace. Indeed, as further described below, the Exchange has

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

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

<sup>3</sup> In Amendment No. 1, the CHX revised several references in the proposal to reflect its members' November 2004 vote to approve the proposed demutualization.

<sup>4</sup> 15 U.S.C. 78f.

proposed specific provisions in the Bylaws of both CHX Holdings and the CHX that reinforce the ability of the Exchange to perform its self-regulatory functions.

### c. Summary of Proposed Rule Change

The proposed rule change is outlined below.<sup>7</sup> In general, the proposed rule change consists of: organizational changes to the CHX Certificate of Incorporation and Bylaws, reflecting the change in corporate form; governance changes that will reduce the size of the CHX Board and modify certain provisions governing CHX committees; and membership rule changes that are necessary to implement the new CHX trading permit structure, which will replace the existing structure of owning and leasing Exchange memberships as a basis for trading rights. The proposed rule change also includes the CHX Holdings Certificate of Incorporation and Bylaws. CHX Holdings will, on the Effective Date of the demutualization transaction, become the Exchange's parent company. The Exchange is not proposing any significant change to its existing operational and trading structure in connection with the demutualization.<sup>8</sup>

#### (1) Governance Structure of the Demutualized CHX.

(a) *CHX Holdings*. As noted above, following the demutualization, CHX Holdings will be a for-profit stock corporation. All of the issued and outstanding stock of CHX Holdings (450,000 shares of common stock) initially will be owned by the persons or entities that owned memberships in the Exchange.<sup>9</sup>

(i) *Board of Directors*. The Board of Directors of CHX Holdings ("CHX Holdings Board") will consist of between 10 and 16 persons, as determined by the CHX Holdings Board from time to time.<sup>10</sup> Initially, the CHX Holdings Board will have 14 directors, who will be selected by the Chairman, Vice Chairman, and Chief Executive

Officer of the CHX from among the persons currently serving on the Exchange's Board of Governors.<sup>11</sup> The directors of CHX Holdings will be divided into three classes, which will be as nearly equal in number as the total number of directors then constituting the entire CHX Holdings Board. The directors of CHX Holdings will serve staggered three-year terms, with the term of office of one class expiring each year.<sup>12</sup>

The Chairman of the CHX Holdings Board will be elected by the CHX Holdings Board from among the directors on the CHX Holdings Board.<sup>13</sup> He may serve as the Chief Executive Officer of CHX Holdings but may have no other office in CHX Holdings. The Vice Chairman of the CHX Holdings Board will be nominated by the Chairman of the CHX Holdings Board and elected by the CHX Holdings Board.<sup>14</sup> He may hold no other office with CHX Holdings. Neither the Chairman nor the Vice Chairman of CHX Holdings will be subject to any limit on the number of terms that he may serve. Each year, the Nominating and Governance Committee of CHX Holdings will nominate directors for the class of directors standing for election at the CHX Holdings annual meeting of stockholders that year.<sup>15</sup> Each CHX Holdings stockholder will be entitled to one vote for each share of stock owned by that stockholder.<sup>16</sup> At each annual meeting of the stockholders of CHX Holdings at which a quorum is present, the individuals receiving a plurality of the votes cast will be elected directors of CHX Holdings.

In most cases, vacancies on the CHX Holdings Board will be filled by persons nominated by the Chairman and Vice Chairman of CHX Holdings and elected by the CHX Holdings Board.<sup>17</sup> If the vacancy has resulted from removal from office for cause pursuant to stockholder

vote, however, that vacancy may be filled by a vote of the stockholders of CHX Holdings at the same meeting at which that director is removed. Any director chosen to fill a vacancy or newly-created seat may serve only until the next annual meeting of CHX Holdings stockholders, at which time a director will be elected by the stockholders to serve out the remaining portion of the term of the class to which the director belongs.

(ii) *Officers of CHX Holdings*. The day-to-day business affairs of CHX Holdings will be managed by the Chief Executive Officer of CHX Holdings, who will be appointed by the CHX Holdings Board.<sup>18</sup> The Chief Executive Officer of CHX Holdings may appoint such other officers as he believes are necessary. These officers will have the responsibilities and authority set out in the CHX Holdings Bylaws or given to them by the Chief Executive Officer of CHX Holdings. As an initial matter, the Chief Executive Officer of the CHX will act as the Chief Executive Officer of CHX Holdings and will appoint, as officers of CHX Holdings, such officers of the CHX as he believes are necessary to carry out the business of CHX Holdings.

(iii) *CHX Holdings Committees*. The CHX Holdings Board will have several standing committees.<sup>19</sup> The CHX Holdings Nominating and Governance Committee, which will consist of six directors, will be appointed by the CHX Holdings Board.<sup>20</sup> The Executive, Audit, and Compensation Committees of CHX Holdings will be appointed by the Chairman and Vice Chairman of the CHX Holdings Board, subject to the approval of the CHX Holdings Board.<sup>21</sup> Other committees will be appointed by the Vice Chairman of CHX Holdings, subject to the CHX Holdings Board's approval. Each committee will have the authority and responsibilities as may be determined, from time to time, by the CHX Holdings Board.

(b) *The CHX*. As noted above, following demutualization, the CHX will be a for-profit stock corporation. All of its stock will be held by CHX Holdings.<sup>22</sup>

(i) *Board of Directors*. The CHX Board of Directors ("CHX Board") will consist of between 10 and 16 persons, as

<sup>7</sup> Also outlined below are those provisions of the proposed CHX Holdings Certificate of Incorporation and Bylaws that are directly related to the Exchange's self-regulatory function.

<sup>8</sup> The Exchange, however, is proposing certain revisions to the CHX rules which will delete obsolete rule provisions. These changes are summarized below under "Summary of Rule Change Not Related to Demutualization."

<sup>9</sup> See proposed Article Fourth of the CHX Holdings Certificate of Incorporation. CHX Holdings will have an additional 300,000 shares of authorized, but not issued, common stock and 25,000 shares of authorized, but not issued, preferred stock.

<sup>10</sup> See proposed Article Sixth, Section (b) of the CHX Holdings Certificate of Incorporation and proposed Article II, Section 2 of the CHX Holdings Bylaws.

<sup>11</sup> See proposed Article Sixth, Section (g) of the CHX Holdings Certificate of Incorporation.

<sup>12</sup> A CHX Holdings director may serve for any number of terms, consecutive or otherwise, but no person will be eligible for election or re-election as a director if such person has reached the age of 71.

<sup>13</sup> See proposed Article II, Section 4 of the CHX Holdings Bylaws.

<sup>14</sup> See proposed Article II, Section 5 of the CHX Holdings Bylaws.

<sup>15</sup> See proposed Article II, Section 3 of the CHX Holdings Bylaws.

<sup>16</sup> See proposed Article IV, Section 11 of the CHX Holdings Bylaws.

<sup>17</sup> See proposed Article Sixth, Section (h) of the CHX Holdings Certificate of Incorporation and proposed Article II, Section 6 of the CHX Holdings Bylaws. The Chairman and Vice Chairman of CHX Holdings will be required to provide the names of nominees to fill vacancies to the CHX Holdings Board, in writing, no later than five business days before the date on which the CHX Holdings Board will be asked to vote to fill the vacancies.

<sup>18</sup> See proposed Article VI, Section 4 of the CHX Holdings Bylaws.

<sup>19</sup> See proposed Article V, Section 1 of the CHX Holdings Bylaws.

<sup>20</sup> See proposed Article II, Section 3 of the CHX Holdings Bylaws.

<sup>21</sup> See proposed Article V of the CHX Holdings Bylaws.

<sup>22</sup> See proposed Article Fourth of the CHX Certificate of Incorporation.

determined by the CHX Board from time to time.<sup>23</sup> Initially, the CHX Board will have 14 directors, who will be selected by the Chairman, Vice Chairman, and Chief Executive Officer of the CHX from among the persons currently serving on the Exchange's Board of Governors. The directors will be divided into three classes, which will be as nearly equal in number as the total number of directors then constituting the entire CHX Board permits. The CHX's directors will serve staggered three-year terms, with the term of office of one class expiring each year.<sup>24</sup>

The CHX Board will be composed of the Exchange's Chief Executive Officer, persons who qualify as "participant directors" and persons who qualify as "public directors."<sup>25</sup> One-half of the members of the CHX Board must be public directors. The remaining directors (other than the Chief Executive Officer) must be participant directors.<sup>26</sup> The CHX Board's initial directors will include the Chief Executive Officer,

seven public directors and six participant directors of the CHX.

The Chairman of the CHX Board will be elected by the CHX Board and will be either the Chief Executive Officer of the CHX or one of the public directors on the CHX Board.<sup>27</sup> The Vice Chairman of the CHX Board will be elected by the participant directors from among the participant directors on the CHX Board.<sup>28</sup> Neither the Chairman nor the Vice Chairman of the CHX may hold another office in the Exchange, nor will he be subject to any limit on the number of terms that he may serve.

Each year, the Nominating and Governance Committee of the CHX will nominate directors for the class of directors standing for election at the annual meeting of the CHX stockholders that year.<sup>29</sup> CHX Holdings, as sole stockholder of the CHX, will have the sole right and the obligation to vote for the directors of the CHX nominated by the CHX Nominating and Governance Committee.<sup>30</sup>

Because, in the demutualized CHX, the Exchange's participants are not stockholders of the CHX, they cannot directly elect members of the CHX Board. As described below, the Exchange has set up a procedure that allows participants to be involved in the selection of candidates to fill participant director slots on the CHX Board. This procedure is designed to resemble the process currently used to nominate persons to the CHX's Board of Governors.<sup>31</sup> Under the new procedures, the CHX Nominating and Governance Committee will hold two open meetings with CHX participants for the purpose of receiving recommendations of candidates for election to the positions of participant directors. The CHX Nominating and Governance Committee's initial candidates for nomination will be announced to CHX participants, who will then have the opportunity to identify additional candidates for nomination to those positions by submitting a petition

signed by at least ten participants.<sup>32</sup> If no petitions are submitted within the time frame prescribed by the CHX Bylaws, the CHX Nominating and Governance Committee will nominate the candidates it initially identified. If one or more valid petitions are submitted, the participants will be allowed to vote on the entire group of potential candidates. Each participant will have one vote, per trading permit, with respect to each participant director position that is to be filled, and the persons with the highest number of votes will be nominated by the CHX Nominating and Governance Committee.<sup>33</sup> As noted above, CHX Holdings, as sole stockholder of the CHX, will have the sole right and the obligation to vote for the directors nominated by the CHX Nominating and Governance Committee. The Exchange believes that this process provides a fair opportunity for the participants in the Exchange—its "members" under the Act—to participate in the selection of the Exchange's directors.

In most cases, vacancies on the CHX Board will be filled by persons nominated by the Chairman and Vice Chairman of the CHX and elected by the CHX Board.<sup>34</sup> As with CHX Holdings, if the vacancy has resulted from removal from office for cause pursuant to stockholder vote, however, that vacancy may be filled by a vote of the CHX stockholders at the same meeting at which that director is removed. Any director chosen to fill a vacancy or newly-created seat may serve only until the next annual meeting of the CHX stockholders, at which time a director identified by the CHX Nominating and Governance Committee will be elected by the CHX stockholders to serve out

<sup>32</sup> Under the Exchange's current Bylaws, its members have a similar ability to add candidates to a ballot through the submission of petitions signed by ten CHX members.

<sup>33</sup> As noted below, no participant or participant firm is allowed to hold more trading permits than are necessary to the conduct of business on the Exchange. All trading permits must be held by an active participant or must be held by an active participant firm, where the participant firm has assigned an active participant as its nominee. See proposed CHX Rules, Article II, Rule 2(e).

<sup>34</sup> See proposed Article Fifth, Section (g) of the CHX Certificate of Incorporation and proposed Article II, Section 6 of the CHX Bylaws. The Chairman and Vice Chairman of the CHX will be required to provide the names of nominees to fill vacancies to the CHX Board, in writing, no later than five business days before the date on which the CHX Board will be asked to vote to fill the vacancies. The Exchange believes that having both its Chairman (a public director or the Chief Executive Officer) and its Vice Chairman (a participant director) nominate persons to fill vacancies on the CHX Board provides a well-balanced approach to this important responsibility.

<sup>23</sup> See proposed Article Fifth of the CHX Certificate of Incorporation and proposed Article II, Section 2 of the CHX Bylaws. The CHX's current Board of Governors consists of 24 governors.

<sup>24</sup> Under the proposed CHX Bylaws, a CHX director may serve for any number of terms, consecutive or otherwise, but no person will be eligible for election or re-election as a director if such person has reached the age of 71. These provisions are somewhat different from the Exchange's current Bylaws, which contain restrictions on the number of terms that CHX governors may serve and do not place any age restriction on member governors. The Exchange believes that it is appropriate to remove term restrictions to ensure that persons who would be interested in serving on the CHX Board are not required to leave at the end of a particular number of years, particularly as the number of member firms on the Exchange (and the number of persons who would be eligible to serve on the CHX Board) have decreased over the past several years.

<sup>25</sup> See proposed Article Fifth, Section (c) of the CHX Certificate of Incorporation and proposed Article II, Section 2(b) of the CHX Bylaws. A "public director" is a director who (i) is not a participant or an officer, managing member, partner or employee of an entity that is a participant, (ii) is not an employee of the CHX, CHX Holdings or any of their affiliates, (iii) is not a broker or dealer or an officer or employee of a broker or dealer, or (iv) does not have any other material business relationship with the CHX, CHX Holdings, or any of their affiliates or any broker or dealer. A "participant director" is a director who is a CHX participant or an officer, managing member or partner of an entity that is a CHX participant. The proposed definition of public director will replace the somewhat confusing definitions of non-industry governor and public governor that are set out in the Exchange's current governing documents.

<sup>26</sup> This composition is consistent with the composition of the Exchange's current Board of Governors, which consists of 12 non-industry governors (all of whom currently qualify as public governors), ten member governors (of which four must be on-floor governors and four must be off-floor governors) the Vice Chairman (an on-floor member firm representative) and the Chief Executive Officer.

<sup>27</sup> See proposed Article II, Section 4 of the CHX Bylaws. Under the Exchange's current Bylaws, the CHX Chairman could also be an off-floor member governor. The Exchange believes that it is consistent with principles of good governance to ensure that the Chairman of the Exchange is not one of the members regulated by the Exchange.

<sup>28</sup> See proposed Article II, Section 5 of the CHX Bylaws. Currently, the Exchange's Vice Chairman is directly elected by the Exchange's members.

<sup>29</sup> See proposed Article II, Section 3 of the CHX Bylaws.

<sup>30</sup> CHX Holdings will sign an agreement with the CHX confirming its obligation to vote for the candidates nominated through the process set out in the proposed CHX Bylaws.

<sup>31</sup> See proposed Article II, Section 3 of the CHX Bylaws.

the remaining portion of the term of the class to which the director belongs.

(ii) *Officers of the CHX.* The day-to-day business affairs of the CHX will continue to be managed by its Chief Executive Officer, who is appointed by the CHX Board.<sup>35</sup> The Chief Executive Officer of the CHX will continue to have the authority to appoint such other officers as he believes are necessary. These officers will have the responsibilities and authority set out in the CHX Bylaws or given to them by the Chief Executive Officer of the CHX.<sup>36</sup>

(iii) *CHX Committees.* The CHX Board will have several standing committees, which are, for the most part, the same as the committees currently in place for the CHX.<sup>37</sup>

(A) The CHX Nominating and Governance Committee, which will consist of three participant directors and three public directors, will be appointed by the CHX Board.<sup>38</sup> This committee will be responsible for nominating candidates for the position of director and periodically reviewing the organization and governance structure of the Exchange.<sup>39</sup>

<sup>35</sup> See proposed Article V of the CHX Bylaws.

<sup>36</sup> Although these provisions are not measurably different from the Exchange's current Bylaws, the proposed changes to Article V of the CHX Bylaws do contain two new provisions relating to officer compensation and term of office. Consistent with the existing CHX Rules, proposed Article V, Section 2 of the CHX Bylaws confirms that the CHX Chief Executive Officer's compensation is determined by the CHX Compensation Committee and that salaries of other officers are fixed by the Chief Executive Officer of the CHX, in consultation with the Compensation Committee of the CHX. Proposed Article V, Section 3 of the CHX Bylaws confirms that officers hold office until a successor is appointed or until the officer's death, resignation, or removal. Other changes in proposed Article V of the CHX Bylaws move references to the Exchange's Chairman and Vice Chairman to proposed Article II (Directors) to confirm that these persons are not officers of the Exchange and set out the general authority of Exchange officers.

<sup>37</sup> Information about the composition and responsibilities of the Exchange's committees is contained in proposed Article IV of the Exchange's rules.

<sup>38</sup> Under the Exchange's current rules, the Exchange's Nominating Committee consists of three member representatives (including one on-floor representative and one off-floor representative) and three non-industry persons. The member representatives currently are elected by the Exchange's members; the non-industry representatives are appointed by the Exchange's Board of Governors. The Exchange believes that it is appropriate to adopt a more streamlined approach to the selection of its Nominating and Governance Committee when it demutualizes and thus has chosen the process set out in the amended CHX Bylaws.

<sup>39</sup> In making this proposal, the Exchange seeks to combine the work of its current Nominating Committee with the work performed by its current (and separate) Organization and Governance Committee. The Exchange believes that it will be more efficient to have a single committee address these issues.

(B) The CHX's Executive, Audit, Finance, and Compensation Committees will be appointed by the Chairman and Vice Chairman of the CHX Board, subject to the approval of the CHX Board.<sup>40</sup>

(C) The CHX's Regulatory Oversight Committee will be appointed by the Vice Chairman of the CHX Board, subject to the approval of the public directors on the CHX Board.<sup>41</sup>

(D) The CHX's Judiciary Committee will continue to be appointed by the Chief Executive Officer of the CHX; and

(E) Other committees, including the newly-formed Participant Advisory Committee of the CHX, will be appointed by the Vice Chairman of the CHX, subject to the CHX Board's approval.<sup>42</sup> Each committee will have the authority and responsibilities as

<sup>40</sup> The role and composition of these committees are similar, but not identical, to the structure under the current CHX rules. For example, under the revised CHX rules, a majority (not just 50%) of the members of the CHX's Audit and Compensation Committees would be public directors. In addition, the description of the CHX Audit Committee's role would be updated to confirm that the committee (not the CHX Board) has the direct responsibility to retain and oversee the work of the independent public accountant that audits the Exchange's financial statements. Other changes include a decision to streamline the requirements for CHX Executive Committee members by removing the requirement in the Exchange's current Bylaws that committee members be chosen (a) with a view to providing representation to the various geographical areas in which there are member organizations that support the Exchange; and (b) with a view to having persons on the committee who are interested in and knowledgeable about the Exchange's business operations and the securities industry as a whole. These requirements appear to have been included in the Exchange's Bylaws at a time when securities industry participants had businesses that were more local in scope and when persons might not have had a particular interest in serving as public directors on the CHX's Board of Governors. Today, the businesses of many of the Exchange's members are national in scope and the Exchange anticipates that all of its public directors will be interested in learning more about the Exchange's operations and the workings of the securities industry as a whole.

<sup>41</sup> The CHX represents that the composition, responsibilities, and appointment mechanism associated with this committee are consistent with the requirements relating to this committee that are set out in the CHX's September 30, 2003, settlement order with the Commission. See *In the Matter of the Chicago Stock Exchange*, Securities Exchange Act Release No. 48566 (September 30, 2003) (Admin. Proc. File No. 3-11282) (Order Instituting Public Administrative Proceedings Pursuant to Sections 19(h) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Censure, a Cease-and-Desist Order and Other Relief) ("CHX Settlement Order").

<sup>42</sup> The CHX Participant Advisory Committee will be composed entirely of participants of the Exchange. It will, among other things, recommend rules for adoption by the CHX Board and advise the CHX management regarding enhancements to the Exchange's trading facilities and other matters that affect participants. This committee is designed to provide participants with a formal opportunity to share their concerns and ideas with the CHX management.

may be determined, from time to time, by the CHX Board.

(2) *Provisions Relating to, or Arising from, the Self-Regulatory Functions of the CHX.* The proposed Bylaws of both CHX Holdings and the CHX contain specific provisions relating to the self-regulatory function of the CHX.

(a) *CHX.* For the CHX, these provisions address the following issues:

(i) *Management of the CHX.* The CHX Board must consider applicable requirements under Section 6(b) of the Act<sup>43</sup> in connection with the management of the Exchange.<sup>44</sup>

(ii) *Confidentiality.* Meetings of the CHX Board and of its committees that pertain to the self-regulatory function of the Exchange or to the structure of the market which the Exchange regulates must be closed to persons who are not members of the CHX Board or CHX officers, staff, counsel, or other specifically identified persons.<sup>45</sup> The CHX books and records that relate to the Exchange's self-regulatory function must be kept confidential and must not be used for non-regulatory purposes.<sup>46</sup>

(iii) *Maintenance of books and records.* All of the books and records of the CHX must be maintained at a location within the United States.<sup>47</sup>

(iv) *Regulatory fees and penalties.* Any revenues received by the CHX from regulatory fees or penalties must be applied to fund the legal and regulatory operations of the Exchange and must not be used to pay dividends.<sup>48</sup>

<sup>43</sup> 15 U.S.C. 78f(b). Section 6(b) of the Act requires, among other things, that the Exchange's rules must be designed to protect investors and the public interest. It also requires that the Exchange be organized so that it can carry out the purposes of the Act and to enforce compliance by its participants with the Act, the rules and regulations under that Act, and the rules of the Exchange.

<sup>44</sup> See proposed Article X, Section 1 of the CHX Bylaws.

<sup>45</sup> See proposed Article X, Section 2 of the CHX Bylaws. These requirements are designed to ensure that representatives of CHX Holdings or of other corporations affiliated with the Exchange do not improperly involve themselves in specific disciplinary or other regulatory matters being handled by the Exchange. These requirements and the requirements relating to the confidentiality of records are not, however, designed to prevent the Exchange from sharing with CHX Holdings the type of information about the Exchange's business that would ordinarily be shared with a parent corporation, including information relating to the Exchange's compliance with the CHX Settlement Order and all applicable laws; any reports from the Commission or from others evaluating the Exchange's self-regulatory programs; and information about the trading activities and business strategies of the Exchange's participants.

<sup>46</sup> See proposed Article X, Section 3 of the CHX Bylaws.

<sup>47</sup> See proposed Article X, Section 4 of the CHX Bylaws.

<sup>48</sup> See proposed Article X, Section 5 of the CHX Bylaws. Regulatory penalties that are intended to

*(v) Restrictions on ownership.*

Although there are no percentage-based restrictions on the ownership of the CHX, the proposed CHX Certificate of Incorporation confirms that CHX Holdings is the sole stockholder of the CHX.<sup>49</sup> Changes to the CHX Certificate of Incorporation cannot take effect until they are approved by the Commission.

*(b) CHX Holdings.* Provisions in the CHX Holdings Certificate of Incorporation and Bylaws address similar, but slightly different, issues and contain specific limitations on shareholder voting and ownership rights, including:

*(i) Restrictions on voting rights.* As described in proposed Article Fifth of the CHX Holdings Certificate of Incorporation, holders of the common stock or preferred stock of CHX Holdings, either alone or together with any of their affiliates or associates or any other person, directly or indirectly, may not (a) vote or give a proxy or consent with respect to shares representing more than 20% of the voting power of the then-issued and outstanding capital stock of CHX Holdings or (b) enter into any agreement, plan, or arrangement that would result in the shares of capital stock of CHX Holdings, subject to that agreement, plan, or arrangement, not being voted on a matter or any proxy being withheld, where the effect of that agreement, plan, or arrangement would be to enable any person or group to obtain more than 20% of the outstanding voting power.

*(ii) Restrictions on ownership rights.* In addition to the restrictions on voting discussed above, shares of common stock of CHX Holdings will be subject to the following restrictions: (a) no person, alone or together with its affiliates and associates or any person(s) acting in concert with it, may own of record or beneficially, directly or indirectly, more than 40% of the outstanding shares of any class of capital stock of CHX Holdings; and (b) no person, alone or together with its affiliates and associates or any person(s) acting in concert with it, who holds a trading permit of the CHX, may own of record or beneficially, directly or indirectly, more than 20% of any class of capital stock of CHX Holdings. These restrictions may be waived by the CHX Holdings Board in accordance with the terms of the Certificate of Incorporation of CHX Holdings and an appropriate

benefit customers, by, for example, providing restitution, must be provided to those customers and will not be used by the Exchange for any purpose.

<sup>49</sup> See proposed Article Fourth of the CHX Certificate of Incorporation.

amendment to the Bylaws of CHX Holdings, which must be approved by the Commission.<sup>50</sup>

*(iii) Management of CHX Holdings.* So long as CHX Holdings controls the Exchange, the CHX Holdings Board and its officers, employees and agents must give due regard to the preservation of the independence of the Exchange's self-regulatory function and to its obligations to investors and the public interest and must not take actions that would interfere with the self-regulatory activities of the Exchange.<sup>51</sup>

*(iv) Confidentiality.* The CHX Holdings books and records that relate to the Exchange's self-regulatory function must be kept confidential and must not be used for non-regulatory purposes.<sup>52</sup>

*(v) Cooperation with the Commission/consent to jurisdiction.* To the extent that they are related to the activities of the CHX, the books, records, officers, directors, and employees of CHX Holdings will be deemed to be the books, records, officers, directors, and employees of the Exchange for purposes of the Commission oversight.<sup>53</sup> Additionally, CHX Holdings officers, directors, employees, and agents are deemed to agree to cooperate with the Commission in its oversight activities relating to the Exchange and are deemed to submit to the jurisdiction of the Commission with respect to proceedings that might arise out of, or relate to, the activities of the Exchange.<sup>54</sup>

*(3) Trading Permits.*

Following the Exchange's demutualization, persons and firms who have been qualified for membership under Articles 1, 2, or 3 of the Exchange's current rules and, as a result, have access to the Exchange's trading floor and other facilities will separately receive trading permits entitling them to maintain the same trading access to the CHX that they currently enjoy. These persons will separately and automatically be issued one or more trading permits, unless they

<sup>50</sup> CHX Holdings stockholders also are prohibited from selling, transferring, or otherwise disposing of their shares except in 1000-share increments, and no stockholder will be permitted to transfer shares in CHX Holdings until all amounts due and owing from that stockholder to the CHX have been paid. See proposed Article IX, Sections 2 and 3(b) of the CHX Holdings Bylaws.

<sup>51</sup> See proposed Article III, Section 1 of the CHX Holdings Bylaws.

<sup>52</sup> See proposed Article III, Section 2 of the CHX Holdings Bylaws.

<sup>53</sup> See proposed Article III, Section 3 of the CHX Holdings Bylaws.

<sup>54</sup> See proposed Article III, Sections 4 and 5 of the CHX Holdings Bylaws.

affirmatively "opt out" of the opportunity to obtain a trading permit.<sup>55</sup>

Each trading permit will constitute a revocable license that will allow the holder of the permit to access the CHX trading facilities in the same manner as previously authorized for the CHX's qualified trading members.<sup>56</sup> As summarized below, and with the exceptions noted below, although there will be some changes in terminology and certain administrative procedures following demutualization, the right of a qualified trading member to access the CHX, and execute transactions through the CHX, will not be substantially changed as a result of the demutualization transaction. Persons holding trading permits of the CHX will be "members" of the CHX for purposes of the Act and will be characterized as "participants" in the CHX subject to the CHX's regulatory jurisdiction, but they will not have any ownership interest in the Exchange or in CHX Holdings by virtue of their trading permits.<sup>57</sup>

Following demutualization, persons other than qualified trading members who seek issuance of a trading permit will be required to complete appropriate application materials and registration forms, satisfy regulatory requirements and pay processing charges and application fees. This process will be substantially similar to the current membership application process.<sup>58</sup> An individual participant may obtain only one trading permit. A participant that is not an individual (*i.e.*, a participant firm) may obtain multiple trading permits and may assign a nominee to each trading permit. A trading permit will be required for each person transacting business. As an example, a CHX specialist firm with 50 co-specialists will be required to obtain 50 trading permits and to register each co-specialist as a nominee. Importantly, however, no participant or participant firm will be allowed to hold more

<sup>55</sup> The Exchange will circulate written materials to all qualified trading members, in advance of the Effective Date, notifying these persons that they can decide not to receive a trading permit and setting out the procedures by which that opt-out decision can be made. See Amendment No. 1, *supra* note 3.

<sup>56</sup> See proposed CHX Rules, Article II, Rule 2, "Rights and Privileges of Participants."

<sup>57</sup> See proposed CHX Rules, Article I, Rule 1(l) (definition of "participant").

<sup>58</sup> See proposed CHX Rules, Articles II and III. Other than the new rules relating to trading permits, the changes to the rules in these articles replace references to a "member," "member organization" and "member firm" with the words "participant" and "participant firm," delete references to sales of memberships, and consolidate the current separate articles that relate to member firms and member corporations into a single article regarding participant firms. These changes are not designed to alter the substantive rights and obligations of the CHX members.

trading permits than are necessary to the conduct of business on the Exchange. All trading permits must be held by an active participant or must be held by an active participant firm, where the participant firm has assigned an active participant as its nominee.<sup>59</sup>

Once issued, a trading permit of the CHX will be effective for one year following its issuance date and will automatically renew for an additional one-year term on each anniversary of the issuance date, unless the holder notifies the Exchange (by giving not less than 60 days' notice) that the holder wishes to waive its right to this automatic renewal. If the participant waives the right to renew the permit, it will expire at the end of the then-current term.<sup>60</sup> A trading permit may not be sold, leased or otherwise transferred.<sup>61</sup> As an exception to the non-transferability of trading permits, a trading permit may be transferred to the name of a nominee within the same participant firm with the approval of the CHX. In addition to the holder's right to relinquish a trading permit, the CHX may suspend or revoke a trading permit for the same reasons that currently entitle the CHX to suspend or revoke a membership and/or sell a seat.<sup>62</sup>

Currently, the Exchange's rules permit a person (referred to as an "approved lessor") to purchase a membership solely for the purpose of providing a financing mechanism for another person that seeks access to the Exchange.<sup>63</sup> Following demutualization, the Exchange's rules will be amended to delete Article IA of the CHX rules. Accordingly, following demutualization, no person may operate as an approved lessor or otherwise lease trading access to the Exchange.

There will be nominal processing charges and application fees relating to the issuance of trading permits. In addition, all participants and participant firms will be subject to an initial annual trading permit fee of \$6,000 per year, payable monthly, for each trading permit.<sup>64</sup> These new fees are set out in the proposed amendments to the Schedule of Member Dues and Fees.<sup>65</sup>

#### (4) *Other Provisions in the Certificate of Incorporation and Bylaws*

(a) *Stockholder Ownership.* The proposed Bylaws for CHX Holdings and the CHX contain a variety of provisions relating to issues associated with stockholder ownership, including provisions relating to the timing and conduct of meetings, record dates, quorum requirements, proxies, and other matters.<sup>66</sup> These provisions are designed to reflect current corporate practices and are identical for CHX Holdings and the CHX.

(b) *Updated provisions of the CHX Charter and Bylaws.* The Exchange is proposing a few changes to its Bylaws and Certificate of Incorporation to modernize the Exchange's governing documents. Among other things, the Exchange is proposing: to include a streamlined description of its corporate purpose; to confirm that the CHX Board has the authority to set the CHX Board's compensation; to set out specific provisions relating to the authority of Exchange officers to enter into contracts, sign checks, and handle the funds of the Exchange; and to specifically provide that the Exchange will advance expenses, in appropriate circumstances, to directors, officers, and committee members of the CHX who are named as defendants in certain actions relating to Exchange business.<sup>67</sup> Identical provisions are proposed for the Certificate of Incorporation and Bylaws of CHX Holdings. The Exchange believes that these provisions are consistent with current corporate practices relating to these issues.

(5) *Summary of Rule Change Not Related to Demutualization.* In connection with its comprehensive review of its rules as part of this demutualization, the Exchange is proposing to delete the following rule provisions that relate to events that have already occurred or to programs that the Exchange no longer offers: Article IB, "E-Session Trading Privileges"; Article XI, Rules 11, "Mandatory Year 2000 Testing," and 12, "Mandatory Decimal Pricing Testing;" and Article XIII, Rule 4, "Advertisements, Market Sales Literature Relating to Options and Communications to Customers."

#### (6) *Administrative Issues*

(a) *Membership market.* CHX members will be able to buy and sell CHX memberships until the close of the

seat market on the 11th business day prior to the expected Effective Date of the demutualization transaction.<sup>68</sup> All existing bids and offers in the seat market will be immediately cancelled at the close of the seat market on that day because the required posting procedures associated with any transactions consummated after that date could not be completed before the Effective Date of the transaction. This hiatus in the membership market will permit the Exchange to identify with certainty the persons and firms who hold membership interests and are entitled to receive shares on the Effective Date of the transaction.

(b) *Approval of demutualization transaction.* Under the Exchange's rules, an approved lessor who is not a qualified trading member of the Exchange is not entitled to vote his membership interest. If such a membership interest is leased to an Exchange member, the lessee may vote the membership interest, but, if the membership interest has not been leased, there is no vote associated with that membership interest.

The CHX's Board of Governors determined that it is appropriate to provide these approved lessors holding unleased membership interests with an opportunity to vote on the demutualization transaction. As a result, the CHX's Board of Governors conditioned the demutualization transaction on approval by the affirmative vote of both (1) a majority of the membership interests entitled to vote on the election of governors of the Exchange, and (2) a majority of all of the outstanding memberships of the Exchange. The first vote count was conducted in a manner consistent with prior votes of Exchange members and included votes cast with respect to memberships owned by (a) qualified trading members of the Exchange (whether or not those memberships are leased to other CHX members) and (b) approved lessors who were not qualified trading members of the Exchange where the memberships are leased to CHX members. The second vote count included all of the votes cast in the first count, as well as votes cast by approved lessors who were not qualified trading members of the Exchange where the memberships were not leased to CHX members. On November 11, 2004, the persons voting in these two vote counts approved the proposal to demutualize the CHX.<sup>69</sup>

<sup>59</sup> See proposed CHX Rules, Article II, Rule 2(e).

<sup>60</sup> See proposed CHX Rules, Article II, Rules 3(d), "Term of Trading Permit," and 7, "Termination of Trading Permit by Participant."

<sup>61</sup> See proposed CHX Rules, Article II, Rule 6, "Transfers of Trading Permits."

<sup>62</sup> See generally, CHX Rules, Articles VII, "Suspension—Reinstatement," and XII, "Discipline and Trial Proceedings."

<sup>63</sup> See CHX Rules, Article IA.

<sup>64</sup> This fee is identical to the fee currently charged by the Exchange for membership dues.

<sup>65</sup> See proposed Schedule of Membership Dues and Fees.

<sup>66</sup> See proposed Article IV of the CHX Holdings Bylaws and proposed Article III of the CHX Bylaws.

<sup>67</sup> See proposed CHX Certificate of Incorporation, Article Third (corporate purpose) and proposed CHX Bylaws Article II, Section 15 (board compensation), Article IX (contracts, loans, checks and deposits), and Article VI (indemnification and advancing of expenses).

<sup>68</sup> See Amendment No. 1, *supra* note 3.

<sup>69</sup> See Amendment No. 1, *supra* note 3.

## 2. Statutory Basis

The CHX believes the proposal is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities exchange, and, in particular, with the requirements of Section 6(b) of the Act.<sup>70</sup> The CHX believes the proposal is consistent with Section 6(b)(5) of the Act<sup>71</sup> in that it would create a governance and regulatory structure of the Exchange that is designed to promote just and equitable principles of trade, to remove impediments, and to perfect the mechanism of, a free and open market and a national market system, and, in general, to protect investors and the public interest. The Exchange represents that it remains committed to its role as a national securities exchange and does not believe that the proposed change to a for-profit institution will undermine its responsibilities for regulating its marketplace. Indeed, as described above, the Exchange believes that it has proposed specific provisions in the Bylaws of both CHX Holdings and the demutualized CHX that reinforce the ability of the Exchange to perform its self-regulatory functions.

Moreover, according to the CHX, the Exchange is not proposing any significant changes to its existing operational and trading structure in connection with the demutualization. Instead, the CHX represents that the proposed rule change primarily consists of: organizational changes to the CHX Certificate of Incorporation and Bylaws reflecting the change in corporate form; governance changes that will reduce the size of the CHX Board and modify certain provisions governing the CHX committees; and membership rule changes that are necessary to implement the new CHX trading permit structure, which will replace the existing structure of owning and leasing Exchange memberships as a basis for trading rights. The proposed rule change also includes the CHX Holdings Certificate of Incorporation and Bylaws. Although the proposed governance structure does not reflect all of the proposals put forward by the Commission in its latest release on self-regulatory governance,<sup>72</sup> the Exchange believes that it is consistent with governance changes approved by the Commission for other demutualized exchanges and does not serve to erode the principles articulated

in the Commission's recent governance release.

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

The Exchange does not believe that the proposed rule change will impose any inappropriate burden on competition.

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

No written comments were either solicited or 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 other 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 the self-regulatory organization consents, the Commission will:

(A) By order approve the 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 proposal is consistent with the Act. Comments may be submitted by any of the following methods:

### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CHX 2004-26 on the subject line.

### Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609.

All submissions should refer to File No. SR-CHX-2004-26. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/>

[rules/sro.shtml](#)). 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 changes 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, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing will also be available for inspection and copying at the principal office of the CHX. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. SR-CHX-2004-26 and should be submitted on or before January 18, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>73</sup>

**Margaret H. McFarland,**  
Deputy Secretary.

[FR Doc. 04-28275 Filed 12-27-04; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50887; File No. SR-DTC-2004-11]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Expand the Depository Trust Company's SMART/Track Service To Include Corporate Action Liability Notification

December 20, 2004.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on November 15, 2004, the Depository Trust Company ("DTC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change described in items I, II, and III below, which items have been prepared primarily by DTC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested parties.

<sup>73</sup> 17 CFR 200.30-3(a)(12).

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

<sup>70</sup> 15 U.S.C. 78f(b).

<sup>71</sup> 15 U.S.C. 78f(b)(5).

<sup>72</sup> See Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004) (File No. S7-39-04).