

intends to implement the proposed rule change, as amended, on July 3, 2006.

At any time within 60 days of the filing of the proposed rule change, as amended, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.<sup>12</sup>

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended, 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*. Please include File Number SR-NASD-2006-065 on the subject line.

##### Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2006-065. 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 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 also will be

<sup>12</sup> The effective date of the original proposed rule change is May 23, 2006, and the effective date of Amendment No. 1 is May 31, 2006. For purposes of calculating the 60-day period within which the Commission may summarily abrogate the proposed rule change, as amended, under Section 19(b)(3)(C) of the Act, the Commission considers the period to commence on May 31, 2006, the date on which NASD submitted Amendment No. 1. *See* 15 U.S.C. 78s(b)(3)(C).

available for inspection and copying at the principal office of NASD. 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 Number SR-NASD-2006-065 and should be submitted on or before July 6, 2006.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>13</sup>

**J. Lynn Taylor,**  
Assistant Secretary.

[FR Doc. 06-5419 Filed 6-14-06; 8:45 am]  
BILLING CODE 8010-01-M

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-53963, File No. SR-NSX-2006-03]

### Self-Regulatory Organizations; National Stock Exchange<sup>SM</sup>; Order Approving Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to the Demutualization of the National Stock Exchange

June 8, 2006.

#### I. Introduction

On April 5, 2006, the National Stock Exchange<sup>SM</sup> ("NSX" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and

<sup>1</sup> 17 CFR 200.30-3(a)(12).

<sup>2</sup> 15 U.S.C. 78s(b)(1).

<sup>3</sup> 17 CFR 240.19b-4.

<sup>3</sup> Amendment No. 1 ("Amendment No. 1") made revisions to the proposed Holdings Certificate of Incorporation, Sections (b)(iii)(B) and (C); Holdings By-Laws, Article III, Sections 3.1 and 3.4; NSX By-Laws, Article III, Section 3.2(b); and NSX Rule 2.10. In addition, Amendment No. 1 added new proposed Section 3.6 to Article III of the Holdings By-Laws, requiring Holdings to take reasonable steps necessary to cause its officers, directors, and employees to consent to the applicability to them of Article III of the Holdings By-Laws. Finally, Amendment No. 1 made corresponding changes to Item 3 of Form 19b-4 and Exhibit 1 to describe the effect of the foregoing Exhibit 5 revisions and also add a description of proposed NSX Rule 2.10.

<sup>4</sup> Amendment No. 2 ("Amendment No. 2") made changes to Item 3 of Form 19b-4 and Exhibit 1, which changes were incorporated into the notice; *see infra*, note 5.

<sup>5</sup> See Securities Exchange Act Release No. 53721 (April 25, 2006), 71 FR 26155 (May 3, 2006) ("Demutualization Notice").

<sup>6</sup> See Letter from Ann Yerger, Executive Director, Council of Institutional Investors to Nancy M. Morris, Secretary, Commission, dated May 11, 2006 ("CII Letter").

<sup>7</sup> See Letter from James C. Yong, Chief Regulatory Officer, Exchange to Nancy M. Morris, Secretary, Commission, dated June 5, 2006 ("NSX Response").

Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to effect a series of proposed changes to the Exchange's corporate structure that would allow for the demutualization of the Exchange. On April 19, 2006, the NSX submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> On April 25, 2006, the NSX submitted Amendment No. 2 to the proposed rule change, as amended.<sup>4</sup> The proposed rule change, as amended, was published for comment in the **Federal Register** on May 3, 2006.<sup>5</sup> The Commission has received one comment on the proposal.<sup>6</sup> The NSX submitted a response to the comment on June 5, 2006.<sup>7</sup> This order approves the proposed rule change, as amended.

#### II. Description of Proposed Rule Change

##### a. Description of Demutualization Transaction

Currently, NSX is a non-stock nonprofit Ohio corporation. NSX proposes to demutualize by reorganizing as a Delaware for-profit stock corporation that would be a direct and wholly-owned subsidiary of a new Delaware for-profit stock holding company ("Holdings"). To accomplish the demutualization, NSX has established (i) two new Delaware stock for-profit corporations: Holdings, a direct and wholly-owned subsidiary of NSX, and NSX Delaware Merger Sub, Inc. ("NSX Delaware Merger Sub"), a direct and wholly-owned subsidiary of Holdings, and (ii) one transitory Ohio stock for-profit corporation, NSX Ohio Merger Sub, Inc. ("NSX Ohio Merger Sub"), also a direct and wholly-owned subsidiary of Holdings.<sup>8</sup>

Pursuant to an agreement and plan of merger, NSX would merge ("Merger #1") with and into NSX Ohio Merger Sub, with NSX Ohio Merger Sub surviving the merger as an Ohio for-profit stock corporation that is a direct and wholly-owned subsidiary of Holdings. As a result of Merger #1, NSX Ohio Merger Sub will be the initial successor-in-interest to NSX. Immediately following Merger #1, pursuant to a second agreement and plan of merger, NSX Ohio Merger Sub would merge ("Merger #2") with and into NSX Delaware Merger Sub, with NSX Delaware Merger Sub renamed National Stock Exchange, Inc. surviving the merger as a Delaware for-profit stock

<sup>8</sup> The Exchange stated that the establishment of NSX Ohio Merger Sub and the process of demutualization through two mergers (as described more fully in this document) are necessitated because under Ohio law, NSX, as an Ohio nonprofit corporation, may not merge directly with and into a foreign for-profit corporation, such as NSX Delaware Merger Sub.

corporation that is a direct and wholly-owned subsidiary of Holdings.<sup>9</sup>

In the Demutualization Notice, the Exchange stated that upon completion of Merger #2, NSX, the Delaware for-profit stock corporation, would be, in effect, the successor-in-interest to NSX, the current Ohio non-stock nonprofit corporation, and would assume all of the assets and liabilities of the Exchange, including, without limitation, the adherence to, and the performance of, the undertakings under the *Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 19(b) and 21C of the Securities Exchange Act of 1934, Making Findings and Imposing Sanctions*, entered by the Commission on May 19, 2005<sup>10</sup> (the "Order").<sup>11</sup> NSX stated that it would continue to engage in the business of operating a national securities exchange registered under Section 6 of the Act.<sup>12</sup>

Presently, the members of NSX hold certificates of proprietary membership in NSX and have a right to trade on the exchange operated by NSX. On the effective date of the demutualization (the "Effective Date"), each member of NSX would receive 1,000 shares of Holdings Class A common stock<sup>13</sup> for the first certificate of proprietary membership of NSX held by the member and would receive a modestly discounted number of shares of Class A common stock (determined by a formula set forth in the Merger #1 merger agreement) for each additional

<sup>9</sup> The term "NSX" in this document will also refer to the Exchange as a Delaware for-profit stock corporation after the demutualization.

<sup>10</sup> See Securities Exchange Act Release No. 51714.

<sup>11</sup> See Demutualization Notice.

<sup>12</sup> 15 U.S.C. 78f. Following the demutualization, the Exchange stated that earnings of NSX not retained in its business may be distributed to its parent, Holdings, and Holdings would be authorized to pay dividends to the stockholders of Holdings as and when they are declared by the Board of Directors of Holdings, but subject to the limitation under the proposed NSX By-Laws that any revenues received by NSX from regulatory fees or penalties may not be used to pay dividends. See proposed NSX By-Laws, Section 10.4.

<sup>13</sup> Holdings would be authorized to issue 1,100,000 shares of common stock having a par value of \$.0001 per share (of which 900,000 shares will be designated as Class A common stock, 100,000 shares will be designated as Class B common stock and 100,000 shares will be designated as Class C common stock) and 100,000 shares of preferred stock having a par value of \$.0001 per share. The Class A common stock would be entitled to one vote per share, absent a provision in the Holdings Certificate of Incorporation fixing or denying voting rights. Neither the Class B nor Class C common stock would be entitled to vote, unless the matter at issue would alter the rights, preferences, privileges or limitations (other than the right to vote) of that stock, respectively, without also altering the rights, preferences, privileges and limitations of the Class A common stock in an identical manner. See proposed Holdings Certificate of Incorporation, Article Fourth, and proposed Holdings By-Laws, Section 4.10.

certificate held. If, however, the total number of Class A shares to be received by a member that would hold an equity trading permit entitling it to trading access on the Exchange after the demutualization (an "ETP Holder"), together with any Class A shares to be received by that member's Related Persons,<sup>14</sup> would exceed 20% of the total number of Class A shares issued (and thus be in violation of an ownership limitation under the proposed Holdings Certificate of Incorporation<sup>15</sup>), that member would receive shares of Class C common stock<sup>16</sup> (which would generally not be entitled to the right to vote) in lieu of the shares of Class A common stock that are in excess of the 20% ownership limitation (and that the member would have received were the 20% ownership limitation not in effect under the proposed Holdings Certificate of Incorporation).

The Chicago Board Options Exchange, Incorporated ("CBOE") owns certificates of proprietary membership in NSX but is not a member of NSX. In the demutualization, CBOE would receive shares of Holdings Class B common

<sup>14</sup> Under the proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (a)(ii), "Related Persons" means, with respect to any Person: (A) Any "affiliate" of such Person (as such term is defined in Rule 12b-2 under the Act); (B) any other Person with which such first Person has any agreement, arrangement or understanding (whether or not in writing) to act together for the purpose of acquiring, voting, holding or disposing of shares of the capital stock of the Corporation; (C) in the case of a Person that is a company, corporation or similar entity, any executive officer (as defined under Rule 3b-7 under the Act) or director of such Person and, in the case of a Person that is a partnership or limited liability company, any general partner, managing member or manager of such Person, as applicable; (D) in the case of an ETP Holder, any Person that is associated with the ETP Holder (as determined using the definition of "person associated with a member" as defined under Section 3(a)(21) of the Act); (E) in the case of a Person that is an individual, any relative or spouse of such Person, or any relative of such spouse who has the same home as such Person or who is a director or officer of the Corporation or any of its parents or subsidiaries; (F) in the case of a Person that is an executive officer (as defined under Rule 3b-7 under the Act) or a director of a company, corporation or similar entity, such company, corporation or entity, as applicable; and (G) in the case of a Person that is a general partner, managing member or manager of a partnership or limited liability company, such partnership or limited liability company, as applicable.

<sup>15</sup> See *infra* subsection II.b.(1)(a)(iv).

<sup>16</sup> Each share of Class C common stock issued would be convertible, at the option of its holder, to one share of Class A common stock upon the satisfaction of certain notification and other requirements under the Holdings Certificate of Incorporation, but only to the extent that the conversion does not violate the limitations on ownership, transfer and voting applicable to Class A common stock under the Holdings Certificate of Incorporation, as more fully described in this document. See proposed Holdings Certificate of Incorporation, Article Fourth, paragraph (d).

stock (which is generally not entitled to the right to vote) in exchange for its certificates of proprietary membership in NSX that are subject to put and call rights under a Termination of Rights Agreement between NSX and CBOE dated September 27, 2004 (the "TORA"),<sup>17</sup> and would receive shares of Holdings Class A common stock in exchange for the remainder of its certificates of proprietary membership.<sup>18</sup> The number of Class A and Class B shares received by CBOE would be based on the discount formula set forth in the Merger #1 merger agreement.

Following the demutualization, persons and entities who have been qualified for membership under the Exchange's current Rules and, as a result, have access to the Exchange's trading facilities would separately receive NSX equity trading permits ("ETPs") entitling them to maintain their trading access to NSX and, as noted above, would be referred to as "ETP Holders." Shares of Holdings capital stock and ETPs would not be tied together. Following the demutualization, former NSX members would be able to sell the shares of Holdings capital stock they receive in connection with the demutualization, subject to the applicable restrictions in the proposed Holdings Certificate of Incorporation and Holdings By-Laws (as described more fully below), while retaining the ability to trade and operate on the Exchange pursuant to their ETPs. Any other person or entity that satisfies the regulatory requirements set forth in the NSX Rules also would be able to obtain an ETP without regard to whether such person is a stockholder of Holdings.

#### b. Summary of Proposed Rule Change

The proposed rule change, as amended, consists of the proposed

<sup>17</sup> In 1986, NSX and CBOE entered into an agreement of affiliation pursuant to which CBOE obtained certificates of proprietary membership in NSX and certain rights associated with NSX, including the right to hold certain seats on the Board of Directors of NSX and certain put rights in connection with its certificates of proprietary membership in NSX. Under the TORA, CBOE agreed to relinquish, upon certain terms, certain of these rights in exchange for cash payments and other undertakings. See Securities Exchange Act Release No. 34-51033 (January 13, 2005), 70 FR 3085 (January 19, 2005) (File No. SR-NSX-2004-12). See also *infra* subsection II.b.(1)(b)(ii).

<sup>18</sup> Each share of Class B common stock would automatically convert to one share of Class A common stock upon its transfer, in accordance with the TORA, to a bona fide third party purchaser unaffiliated with CBOE. See proposed Holdings Certificate of Incorporation, Article Fourth, paragraph (c). NSX stated that the Class B shares would be transferable only under extraordinary circumstances.

Holdings Certificate of Incorporation and Holdings By-Laws and the proposed changes to the Articles of Incorporation and By-Laws of the Exchange that reflect governance and corporate form changes. In addition, the proposed rule change includes proposed changes to the Rules of the Exchange that are necessary to implement the proposed equity trading permit structure. NSX also proposes to move certain provisions in the current By-Laws of NSX respecting members, listing standards, and other matters not relating to the Exchange's corporate governance to the NSX Rules.

(1) Corporate Structure

(a) *Holdings*

Following the demutualization, Holdings would be the parent company and sole stockholder of NSX. NSX stated that all of the issued and outstanding stock of Holdings initially would be owned by the former owners of certificates of proprietary membership in the Exchange.

As sole stockholder of NSX, Holdings would have the right to elect the Board of Directors of NSX, subject to certain provisions in the Holdings By-Laws that require Holdings to vote for certain persons nominated for ETP Holder Director positions and certain persons nominated for CBOE Director positions, in each case in accordance with the revised governance documents of NSX. The Holdings Certificate of Incorporation and the Holdings By-Laws would govern the activities of Holdings.

(i) *Holdings Board of Directors*

The business and affairs of Holdings would be managed by its Board of Directors ("Holdings Board"). The Holdings Board would consist of between 10 and 16 persons, as determined by the Holdings Board, one of which shall be the Chief Executive Officer ("CEO") of Holdings. The Holdings Board would initially have 13 directors after the demutualization. No person that is subject to any "statutory disqualification" (within the meaning of Section 3(a)(39) of the Act) may be a director of Holdings.<sup>19</sup>

The directors of Holdings would be divided into three classes, which would be as nearly equal in number as the total number of directors then constituting the entire Holdings Board. After completion of an initial phase-in schedule, the directors of Holdings would serve staggered three-year terms,

<sup>19</sup> See proposed Holdings Certificate of Incorporation, Article Sixth, Section (a), and proposed Holdings By-Laws, Sections 2.2(a) and (b).

with the term of office of one class expiring each year.<sup>20</sup>

The Holdings Board would elect its Chairman from among the directors on the Holdings Board, and may elect a vice-chairman to perform the functions of the Chairman in his or her absence.<sup>21</sup>

At each annual meeting of the stockholders of Holdings at which a quorum is present, the individuals receiving a plurality of the votes cast of the Class A shares would be elected directors of Holdings.<sup>22</sup> At an election of directors, each Holdings stockholder would be entitled to one vote for each share of Class A common stock owned by that stockholder.<sup>23</sup> Class B and Class C shares shall not be entitled to vote at an election of directors.<sup>24</sup>

In most cases, vacancies on the Holdings Board would be filled by the remaining directors of Holdings. If the vacancy has resulted from a director being removed for cause by the stockholders of Holdings, however, that vacancy may be filled by the stockholders of Holdings at the same meeting at which the director was removed. Any director appointed to fill a vacancy will serve until the expiration of the term of office of the replaced director or until the end of the term for a newly-created directorship.<sup>25</sup>

(ii) *Committees of Holdings*

The Holdings Board would have an Audit Committee, a Governance and Nominating Committee, and such other committees that the Holdings Board establishes.<sup>26</sup> The Chairman of the Holdings Board would appoint the members of all committees of the Holdings Board, and may remove any member so appointed, subject to the approval of the Holdings Board.<sup>27</sup> Each committee would have the authority and duties prescribed for it in the Holdings By-Laws or by the Holdings Board.<sup>28</sup>

(iii) *Officers of Holdings*

The officers of Holdings would be a CEO, a President, a Secretary, a Treasurer, and such other officers as the

<sup>20</sup> See proposed Holdings Certificate of Incorporation, Article Sixth, Section (b), and proposed Holdings By-Laws, Section 2.2(c).

<sup>21</sup> See proposed Holdings By-Laws, Section 2.3(a).

<sup>22</sup> See proposed Holdings By-Laws, Section 4.8.

<sup>23</sup> See proposed Holdings Certificate of Incorporation, Article Fourth, paragraph (b), and proposed Holdings By-Laws, Section 4.10.

<sup>24</sup> See proposed Holdings Certificate of Incorporation, Article Fourth, paragraphs (c) and (d).

<sup>25</sup> See proposed Holdings By-Laws, Section 2.4.

<sup>26</sup> See proposed Holdings By-Laws, Section 5.1.

<sup>27</sup> See proposed Holdings By-Laws, Section 5.2.

<sup>28</sup> See proposed Holdings By-Laws, Section 5.3.

Holdings Board determines.<sup>29</sup> The CEO would be responsible to the Holdings Board for management of the business affairs of Holdings.<sup>30</sup> The officers of Holdings would have the duties and authority set forth in the Holdings By-Laws or given to them by the Holdings Board, and in the case of the President, the Secretary, and the Treasurer, given to them by the Chief Executive Officer.<sup>31</sup> Any two or more offices may be held by the same person, except that the Secretary may not also serve as the CEO or the President. No person that is subject to any "statutory disqualification" (within the meaning of Section 3(a)(39) of the Act) may be an officer of Holdings.<sup>32</sup>

(iv) *Stockholder Restrictions*

The Holdings Certificate of Incorporation and the Holdings By-Laws place certain restrictions on the ability to transfer, own, and vote the capital stock of Holdings.

(1) *Restrictions on Voting*

The Holdings Certificate of Incorporation prohibits any Person,<sup>33</sup> either alone or together with its Related Persons, from (a) voting or giving 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 Holdings; or (b) entering into any agreement, plan, or arrangement that would result in the shares of Holdings subject to that agreement, plan, or arrangement not being voted on a matter, or any proxy relating thereto being withheld, where the effect of that agreement, plan, or arrangement would be to enable any Person, alone or together with its Related Persons, to obtain more than 20% of the voting power of the then-issued and outstanding capital stock of Holdings.<sup>34</sup>

This restriction would not apply to the Class B or Class C common stock and, as to the Class A common stock owned by Persons other than ETP Holders and their Related Persons, may be waived by Holdings Board pursuant to a resolution adopted by the Holdings

<sup>29</sup> See proposed Holdings By-Laws, Section 6.1.

<sup>30</sup> See proposed Holdings By-Laws, Section 6.4.

<sup>31</sup> See proposed Holdings By-Laws, Sections 6.1, 6.4, 6.5, 6.6, and 6.7.

<sup>32</sup> See proposed Holdings By-Laws, Section 6.1.

<sup>33</sup> Article Fifth of the proposed Holdings Certificate of Incorporation defines a "Person" to mean "an individual, partnership (general or limited), joint stock company, corporation, limited liability company, trust or unincorporated organization, or any governmental entity or agency or political subdivision thereof."

<sup>34</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(ii)(C).

Board.<sup>35</sup> Before adopting such resolution, however, the Holdings Board must determine that, among other things, the waiver of the voting limitation will not impair the ability of NSX to carry out its functions and responsibilities under the Act and the rules and regulations promulgated thereunder, and will not impair the Commission's ability to enforce the Act and the rules and regulations promulgated thereunder.<sup>36</sup> In addition, the Holdings Board also must determine that a Person and its Related Persons that would vote more than 20% of the outstanding stock of Holdings are not subject to an applicable "statutory disqualification" (within the meaning of Section 3(a)(39) of the Act).<sup>37</sup> Finally, any resolution of the Holdings Board that would permit a Person to vote more than 20% of the outstanding stock of Holdings must be filed with and approved by the Commission before it becomes effective.<sup>38</sup>

#### (2) Restrictions on Ownership

Under the proposed Holdings Certificate of Incorporation, no Person, either alone or together with its Related Persons, may own shares constituting more than 40% of any class of capital stock of Holdings (other than a class of stock without general voting rights).<sup>39</sup> The Holdings Board may waive this ownership limitation pursuant to a resolution adopted by the Holdings Board. Before adopting such resolution, however, the Holdings Board must determine that, among other things, the waiver of the ownership limitation would not impair the ability of NSX to carry out its functions and responsibilities under the Act and the rules and regulations promulgated thereunder and would not impair the Commission's ability to enforce the Act and the rules and regulations promulgated thereunder.<sup>40</sup>

In addition, the Holdings Board also must determine that any Person and its Related Persons that would own more than 40% of any class of capital stock of Holdings are not subject to any applicable "statutory disqualification"

<sup>35</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraphs (b)(iii)(A) and (B). See Amendment No. 1, *supra* note 3.

<sup>36</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(iii)(B).

<sup>37</sup> 15 U.S.C. 78c(a)(39); see proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(iv).

<sup>38</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(iii)(B).

<sup>39</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraphs (b)(ii)(A) and (b)(iii)(A).

<sup>40</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(iii)(B).

(within the meaning of Section 3(a)(39) of the Act).<sup>41</sup> Finally, any Holdings Board resolution that would permit ownership of Holdings capital stock in excess of the ownership limitation described above must be filed with and approved by the Commission before it becomes effective.<sup>42</sup>

In addition to the ownership restriction described above, no ETP Holder, whether alone or together with its Related Persons, may own shares constituting more than 20% of any class of capital stock of Holdings.<sup>43</sup> However, this ownership restriction would not apply to any ETP Holder, with respect to shares of Class C common stock of Holdings issued to the ETP Holder in connection with, and from the date of, the demutualization of NSX so long as the ETP Holder becomes compliant with the ownership limitation promptly after such issuance.<sup>44</sup>

#### (3) Other Stockholder Ownership and Voting Restriction Requirements

The proposed Holdings Certificate of Incorporation contains several provisions that would enable Holdings to enforce restrictions on the ownership and voting of Holdings capital stock described in the preceding section. Specifically, if a stockholder purports to sell, transfer, assign, or pledge to any Person (other than Holdings) any shares of Holdings that would violate the ownership restrictions, Holdings would record on its books the transfer of only the number of shares that would not violate the restrictions and would treat the remaining shares as owned by the purported transferor, for all purposes, including, without limitation, voting, payment of dividends, and distributions.<sup>45</sup>

In addition, if any stockholder purports to vote, or to grant any proxy or enter into any agreement, plan, or arrangement relating to the voting of shares that would violate the voting restrictions, Holdings would not honor such vote, proxy, or agreement, plan, or other arrangement to the extent that the restrictions would be violated, and any shares subject to that arrangement would not be entitled to be voted to the

<sup>41</sup> 15 U.S.C. 78c(a)(39); see proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(iv).

<sup>42</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraphs (b)(iii)(B) and (C).

<sup>43</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(ii)(B).

<sup>44</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(iii)(C). See Amendment No. 1, *supra* note 3.

<sup>45</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (d).

extent of the violation.<sup>46</sup> Further, if any stockholder purports to sell, transfer, assign, pledge, vote, or own any shares that would violate the ownership and voting restrictions, Holdings would have the right to, and would generally be required to promptly, redeem such shares at a price equal to the par value of the shares.<sup>47</sup> Also, a stockholder that alone or together with its Related Persons owns five percent or more of the then outstanding shares of the capital stock of Holdings entitled to vote in an election of directors must, upon acquiring knowledge of such ownership, immediately give the Holdings Board written notice of such ownership.<sup>48</sup> Holdings may also require any Person reasonably believed to be subject to and in violation of the voting and ownership restrictions to provide to Holdings information relating to such potential violation.<sup>49</sup>

#### (4) Restrictions on Transfer

Members, former members, and other equity owners of NSX who receive shares of capital stock of Holdings in the demutualization may not sell, transfer, or otherwise dispose of those shares for the first thirty days following their issuance, unless the Holdings Board waives this transfer restriction.<sup>50</sup>

Also, unless waived by the Holdings Board or pursuant to a redemption of shares by Holdings, each stockholder of Holdings would be prohibited from selling, transferring, or otherwise disposing of common shares of Holdings except in amounts of at least 1,000 shares (unless the stockholder is transferring all shares owned), and no stockholder would be permitted to transfer any capital stock of Holdings (other than pursuant to a redemption of shares by Holdings) until all amounts due and owing from that stockholder to NSX have been paid.<sup>51</sup>

In the event that a stockholder desires to transfer shares of capital stock of Holdings to any person (other than an affiliate of the stockholder or to another holder of the same class of capital stock) prior to January 1, 2011, Holdings would have a right of first refusal permitting it to purchase those shares,

<sup>46</sup> *Id.*

<sup>47</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (e).

<sup>48</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (c)(i). Such notice must also be updated under certain circumstances. See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (c)(ii).

<sup>49</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (c)(iii).

<sup>50</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(i).

<sup>51</sup> See proposed Holdings By-Laws, Sections 9.4 and 9.5(b).

except for transfers by bequest, operation of law, or judicial decree under certain circumstances.<sup>52</sup>

In addition to these transfer restrictions, shares of Holdings would be “restricted securities” under the Securities Act of 1933 (“Securities Act”) and only may be transferred pursuant to an effective registration statement under the Securities Act and in accordance with applicable state securities laws or, if an exemption from registration is available, upon delivery to Holdings of a satisfactory opinion of counsel that such transfer may be effected pursuant to the exemption. In addition, counsel to Holdings may require delivery of documentation to ensure that the transfer complies with the Securities Act and state securities laws before such transfer is effected.<sup>53</sup> In the Demutualization Notice, the Exchange stated that Holdings had no intention to register its common stock under the Securities Act or the Act, and, unless waived in writing by the Holdings Board, no transfer would be honored by Holdings that would cause Holdings to have to do so or to become subject to the reporting requirements of the Act.<sup>54</sup>

*(v) Self-Regulatory Function and Oversight*

The Holdings By-Laws contain various provisions designed to protect the independence of the self-regulatory function of NSX. For example, under the Holdings By-Laws, for as long as Holdings controls NSX, the Holdings Board and the directors, officers, and employees of Holdings must give due regard to the preservation of the independence of the self-regulatory function of NSX and to its obligations to investors and the general public, and are prohibited from taking actions that would interfere with the effectuation of decisions by the Board of Directors of NSX (“NSX Board”) relating to NSX’s regulatory functions, including disciplinary matters, or which would interfere with NSX’s ability to carry out its responsibilities under the Act.<sup>55</sup>

The Holdings By-Laws also contain a specific requirement that all books and records of NSX, and the information contained therein, that reflect confidential information pertaining to the self-regulatory function of NSX, which come into the possession of Holdings, must be retained in confidence by Holdings and its Board, officers, employees, and agents, and must not be used for any non-regulatory

purposes.<sup>56</sup> In addition, the Holdings By-Laws provide that, to the extent they are related to the activities of NSX, the books, records, premises, officers, directors, agents, and employees of Holdings are deemed to be the books, records, premises, officers, directors, agents, and employees of NSX for the purposes of, and subject to oversight pursuant to, the Act.<sup>57</sup>

Pursuant to the Holdings By-Laws, Holdings must comply with the Federal securities laws and the rules and regulations promulgated thereunder. The Holdings By-Laws also provide that Holdings must cooperate with the Commission and NSX pursuant to and to the extent of their respective regulatory authority, and that the officers, directors, employees, and agents of Holdings, by virtue of their acceptance of such position, are deemed to agree to cooperate with the Commission and NSX in respect of the Commission’s oversight responsibilities regarding NSX and the self-regulatory function and responsibilities of NSX.<sup>58</sup> In addition, the Holdings By-Laws provide that Holdings, its officers, directors, employees, and agents, by virtue of their acceptance of such positions, are deemed to irrevocably submit to the jurisdiction of the U.S. federal courts, the Commission and NSX, for the purpose of any suit, action, or proceeding pursuant to the U.S. federal securities laws, and the rules and regulations promulgated thereunder, arising out of, or relating to, the activities of NSX.<sup>59</sup>

Finally, the Holdings Certificate of Incorporation and the Holdings By-Laws provide that, as long as Holdings controls NSX, before any change to the Holdings Certificate of Incorporation or the Holdings By-Laws, respectively, will be effective, such change must be submitted to the NSX Board, and if the NSX Board determines that the change must be filed with or filed with and approved by the Commission before it may be effective, the change will not be effective until it is filed with, or filed

<sup>52</sup> See proposed Holdings By-Laws, Section 9.6.

<sup>53</sup> See proposed Holdings By-Laws, Section 9.5(a).

<sup>54</sup> See proposed Holdings By-Laws, Section 9.5(c).

<sup>55</sup> See proposed Holdings By-Laws, Section 3.1.

with and approved by, the Commission, as the case may be.<sup>60</sup>

*(b) NSX*

Following the demutualization, NSX would become a Delaware for-profit stock corporation, with the authority to issue 1,000 shares of common stock. At all times, all of the voting stock of NSX would be owned by Holdings.<sup>61</sup> NSX would continue to be the entity registered as a national securities exchange under Section 6 of the Act<sup>62</sup> and, accordingly, NSX would continue to be a self-regulatory organization (“SRO”).<sup>63</sup>

*(i) Governing Documents and NSX Rules*

The proposed NSX Certificate of Incorporation,<sup>64</sup> NSX By-Laws, and NSX Rules (with the proposed changes described in this document) would govern the activities of NSX. NSX stated that these rules and governance documents reflect, among other things, NSX’s status as a wholly-owned subsidiary of Holdings, its management by the NSX Board and its designated officers, and its self-regulatory responsibilities pursuant to NSX’s registration under Section 6 of the Act. NSX’s proposed governance documents are designed to be consistent with its current governance structure, with certain changes based upon its proposed new corporate form.

*(ii) Board of Directors*

After the demutualization, the NSX Board would initially consist of 13 directors. The NSX Board would be initially comprised of the CEO of NSX,

<sup>60</sup> See proposed Holdings Certificate of Incorporation, Article Twelfth, and proposed Holdings By-Laws, Article VIII. These provisions additionally state, respectively, that (i) any change to the proposed Holdings Certificate of Incorporation must also be first approved by the Holdings Board and (ii) any change to the proposed Holdings By-Laws may be made by either the stockholders of Holdings or the Holdings Board. In addition, under Article Fourth, paragraph (e) of the proposed Holdings Certificate of Incorporation, holders of preferred stock (voting separately as single class) must approve any change to the Holdings Certificate of Incorporation that would change the terms of that preferred stock. No preferred stock is currently issued and outstanding.

<sup>61</sup> See proposed NSX Certificate of Incorporation, Article Fourth.

<sup>62</sup> 15 U.S.C. 78f.

<sup>63</sup> In addition, NSX stated that it would continue to adhere to the undertakings in the Order (see *supra note 10*) including, without limitation, the structure provisions of a Regulatory Oversight Committee, the separation of the regulatory functions from the commercial interests of the Exchange, and the retention of third parties to review the Exchange’s regulatory functions.

<sup>64</sup> Due to differences in terminology between Ohio and Delaware law, the Exchange’s Articles of Incorporation are proposed to be renamed its “Certificate of Incorporation.”

3 ETP Holder Directors,<sup>65</sup> 7 Independent Directors,<sup>66</sup> and 2 directors who are executive officers of CBOE, its members,<sup>67</sup> or executive officers of CBOE member organizations.<sup>68</sup> Currently, the Exchange's Board of Directors consists of the CEO of NSX, 3 proprietary members or executive officers of proprietary members, 7 independent directors, and 2 executive officers of CBOE, CBOE members, or executive officers of CBOE member organizations.

Under the proposed rule change, the NSX Board may by resolution increase its size to up to 20 directors. Directors added to the NSX Board to fill these new director positions will be (i) Independent Directors, to the extent necessary for the NSX Board to include at least 50% Independent Directors; (ii) ETP Holder Directors, to the extent necessary for the NSX Board to include at least 20% ETP Holder Directors; and (iii) persons who do not qualify as Independent Directors ("At-Large Directors"), for the remainder of the positions added to the NSX Board that are not filled with Independent Directors or ETP Holder Directors pursuant to clauses (i) and (ii) above. At all times, the NSX Board must include the CEO of NSX, at least 50% Independent Directors and 3 ETP Holder Directors (or such greater number of ETP Holder Directors as is necessary to comprise at least 20% of the NSX Board).<sup>69</sup>

No two or more directors under the proposed NSX By-Laws may be partners, officers, or directors of the same person or be affiliated with the same person, unless such affiliation is with a national securities exchange or Holdings.<sup>70</sup> Directors of NSX other than

<sup>65</sup> An ETP Holder Director is defined under the proposed NSX By-Laws as a director who is an ETP Holder or a director, officer, managing member or partner of an entity that is an ETP Holder. *See proposed NSX By-Laws, Section 1.1(E)(2).*

<sup>66</sup> An Independent Director is defined under the proposed NSX By-Laws as a member of the NSX Board that the NSX Board has determined to have no material relationship with NSX or any affiliate of NSX, or any ETP Holder or any affiliate of any such ETP Holder, other than as a member of the NSX Board. *See proposed NSX By-Laws, Section 1.1(I)(1).* This definition is consistent with the definition of Independent Director in the current By-Laws of NSX. NSX states that at least one Independent Director will be representative of investors; *see Amendment No. 1, supra* note 3.

<sup>67</sup> A CBOE member is defined under the proposed NSX By-Laws as an individual CBOE member or a CBOE member organization that is a regular member or special member of CBOE (as such terms are described in the Constitution of the CBOE), as such CBOE members may exist from time to time. *See proposed NSX By-Laws, Section 1.1(C)(2).*

<sup>68</sup> *See proposed NSX By-Laws, Section 3.2(a).*

<sup>69</sup> *See proposed NSX By-Laws, Section 3.2(b); see Amendment No. 1, supra* note 3.

<sup>70</sup> *See proposed NSX By-Laws, Section 3.2(c).*

the CEO and the CBOE Directors would be divided into three classes, consisting as nearly as possible of equal numbers of directors.<sup>71</sup> After completion of an initial phase-in schedule, these directors would serve for staggered three-year terms, with the term of one class expiring each year. The CEO's appointment as a director would coincide with his or her term as CEO of NSX.<sup>72</sup> The CBOE Directors would each serve a one year term.<sup>73</sup>

Under the proposed NSX By-Laws, the NSX Board is subject to change upon certain events in accordance with the TORA between CBOE and NSX.<sup>74</sup> Under the TORA, CBOE was provided with 4 put rights to transfer its equity interests in NSX to NSX and NSX was provided with 4 call rights on those equity interests. According to NSX, as of March 10, 2006, the first of these put rights was exercised by CBOE, decreasing the number of director positions of NSX filled by a representative of CBOE from 3 to 2 and increasing the number of positions filled by independent directors from 6 to 7. Under the proposed NSX By-Laws:

- On the second closing of a put or call under the TORA, the number of positions on the NSX Board filled by representatives of CBOE will be reduced from 2 to 1. The vacant director position must be filled by an At-Large Director, unless an Independent Director is needed to maintain at least 50% Independent Directors on the NSX Board.<sup>75</sup>

- On the earlier of the date CBOE owns less than 5% of the outstanding capital stock of Holdings or the third anniversary of the fourth closing of a put or call under the TORA, CBOE's appointed positions on the NSX board will decrease to zero. The vacant director position must be filled with an At-Large Director, unless an Independent Director is needed to maintain at least 50% Independent Directors on the NSX Board.<sup>76</sup>

The NSX Board would elect its Chairman from among the directors of the NSX Board. The Chairman of the NSX Board may also serve as the CEO and President of NSX, but may hold no other offices in NSX. Unless the Chairman also serves as the CEO of NSX, the NSX Board must elect the Chairman from among the Independent Directors of the NSX Board.<sup>77</sup>

<sup>71</sup> *See proposed NSX By-Laws, Section 3.4.*

<sup>72</sup> *See proposed NSX By-Laws, Section 3.4(a).*

<sup>73</sup> *See proposed NSX By-Laws, Section 3.4(d).*

<sup>74</sup> *See generally proposed NSX By-Laws, Section 3.3.*

<sup>75</sup> *See proposed NSX By-Laws, Section 3.3(a).*

<sup>76</sup> *See proposed NSX By-Laws, Section 3.3(b).*

<sup>77</sup> *See proposed NSX By-Laws, Section 3.6.*

In most cases, vacancies on the NSX Board would be filled by the remaining directors of NSX. If the vacancy has resulted from a director being removed for cause by the stockholders of NSX, however, that vacancy may be filled by the stockholder of NSX (*i.e.*, Holdings) at the same meeting at which the director was removed. Any director appointed to fill a vacancy would serve until the expiration of the term of office of the replaced director or until the end of the term for a newly-created directorship.<sup>78</sup>

### *(iii) Nomination and Election of Directors*

After the formation of the initial NSX Board, the NSX Governance and Nominating Committee would nominate directors for each director position (other than CBOE director positions) standing for election at the annual meeting of stockholders that year. Candidates for CBOE Directors would be nominated by the Board of Directors of CBOE at its annual meeting or within 20 days of NSX's annual stockholders' meeting. Because ETPs are not equity interests in NSX, ETP Holders are not entitled to directly elect members of the NSX Board. Rather, Holdings, as the sole stockholder of NSX, would have the sole right and the obligation to vote for the directors of the NSX Board.<sup>79</sup>

Specifically, the ETP Holder Director Nominating Committee of NSX (which would be composed solely of ETP Holder Directors and/or ETP Holder representatives) would consult with the NSX Governance and Nominating Committee, the Chairman, and the CEO of NSX and solicit comments from ETP Holders for the purpose of approving and submitting names of ETP Holder Director candidates.<sup>80</sup> These initial candidates for nomination would be announced to ETP Holders, who would then have the opportunity to identify additional candidates for nomination to ETP Holder Director positions by submitting a petition signed by at least ten percent of the ETP Holders. An ETP Holder may endorse as many candidates as there are ETP Holder Director positions to be filled. If no petitions are submitted within the time frame prescribed by the NSX By-Laws, the initial candidates approved and submitted by the ETP Holder Director Nominating Committee would be

<sup>78</sup> *See proposed NSX By-Laws, Section 3.7(a).*

<sup>79</sup> Under Section 10.5(a) of the proposed By-Laws of Holdings, the power to vote the stock of NSX held by Holdings would be with the CEO of Holdings, unless the Holdings Board instructs otherwise or unless the Holdings Board or the CEO of Holdings confers such power on another person.

<sup>80</sup> *See proposed NSX By-Laws, Section 3.5.*

nominated. If one or more valid petitions are submitted, the ETP Holders would vote on the entire group of potential candidates, and the individuals receiving the largest number of votes would be the ETP Holder Director nominees.<sup>81</sup>

*(iv) Committees*

The NSX Board would have the following committees: (1) A Business Conduct Committee; (2) a Securities Committee; (3) an Appeals Committee; (4) a Governance and Nominating Committee; (5) an ETP Holder Director Nominating Committee; (6) a Regulatory Oversight Committee; (7) a Compensation Committee; (8) an Executive Committee; and (9) an Audit Committee.<sup>82</sup> The NSX Board may establish other committees from time to time. Each committee would have the authority and responsibilities prescribed for it in the NSX By-Laws, the rules of the Exchange, or by the NSX Board.<sup>83</sup>

The Chairman of the NSX Board would appoint, and may remove, the members of the committees, subject to the approval of the NSX Board.<sup>84</sup> Each committee must have at least 3 members.<sup>85</sup> The Executive Committee would have the powers that the NSX Board delegates to it, except the power to change the membership of, or fill vacancies in, the Executive Committee.<sup>86</sup> The ETP Holder Director Nominating Committee would have the power to approve and submit names of candidates for election to the position of ETP Holder Director in accordance with the NSX By-Laws.<sup>87</sup> The Regulatory Oversight Committee would oversee all of the regulatory functions and responsibilities of NSX and advise the

<sup>81</sup> Under Section 3.5(e) of the proposed NSX By-Laws, each ETP Holder, regardless of its affiliation with other ETP Holders, will have one vote with respect to each ETP Holder Director position to be filled, but may not cast such votes cumulatively. The CBOE directors are elected by the Board of Directors of CBOE at its January meeting or as soon thereafter as possible. The current By-Laws of NSX also contain a procedure for proprietary member director nominations, whereby one proprietary member director candidate is nominated by the Nominating Committee and additional proprietary member director candidates may be nominated by a petition signed by ten percent or more of the proprietary members. At an annual election during the annual meeting of members, the proprietary members vote for the proprietary member directors among the nominated candidates.

<sup>82</sup> See proposed NSX By-Laws, Section 5.1.

<sup>83</sup> See proposed NSX By-Laws, Sections 5.1 and 5.3.

<sup>84</sup> Under Section 5.2 of the proposed NSX By-Laws, the terms of committee members are subject to the appointment and removal process of the Chairman and NSX Board.

<sup>85</sup> See proposed NSX By-Laws, Section 5.2.

<sup>86</sup> See proposed NSX By-Laws, Section 5.5.

<sup>87</sup> See proposed NSX By-Laws, Section 5.7.

NSX Board on regulatory matters.<sup>88</sup> The Regulatory Oversight Committee's duties and responsibilities are outlined in its charter.<sup>89</sup>

*(v) Management*

The officers of NSX would be a CEO, a President, a Chief Regulatory Officer, a Secretary, and a Treasurer, and such other officers as the NSX Board may determine.<sup>90</sup> Any two or more offices may be held by the same person, except that the Chief Regulatory Officer and the Secretary may not be the CEO or the President.<sup>91</sup> The Chairman of the NSX Board, subject to approval of the NSX Board, may designate one or more officers or other employees of NSX to serve as an Arbitration Director, who would perform or delegate all ministerial duties in connection with matters submitted for arbitration pursuant to the rules of NSX.<sup>92</sup>

*(vi) Self-Regulatory Function and Oversight*

Following the demutualization, NSX would continue to be registered as a national securities exchange under Section 6 of the Act and thus would continue to be an SRO.<sup>93</sup> As an SRO, NSX would be obligated to carry out its statutory responsibilities, including enforcing compliance by ETP Holders with the provisions of the Federal securities laws and the applicable rules of NSX. Further, it would retain the responsibility to administer and enforce the rules that govern NSX and the activities of its ETP Holders. In addition, it would continue to be required to file with the Commission, pursuant to Section 19(b) of the Act<sup>94</sup> and Rule 19b-4 thereunder,<sup>95</sup> any changes to its rules and governing documents. The structural protections adopted by NSX pursuant to the Order help to ensure that NSX's regulatory functions are independent from the commercial interests of NSX and its members would remain in effect following demutualization.

Like the proposed Holdings By-Laws, the proposed NSX By-Laws contain specific provisions relating to the self-

<sup>88</sup> See proposed NSX By-Laws, Section 5.6.

<sup>89</sup> NSX stated that the Regulatory Oversight Committee's charter following demutualization would be the same as the charter previously filed with the Commission, and is consistent with the terms of the Order. See Securities Exchange Act Release No. 34-52573 (October 7, 2005), 70 FR 60113 (October 14, 2005) (File No. SR-NSX-2005-07), strategies of the Exchange's ETP Holders.

<sup>90</sup> See proposed NSX By-Laws, Section 6.1.

<sup>91</sup> See proposed NSX By-Laws, Section 6.1.

<sup>92</sup> See proposed NSX By-Laws, Section 6.6.

<sup>93</sup> See 15 U.S.C. 78c(a)(26).

<sup>94</sup> 15 U.S.C. 78s(b).

<sup>95</sup> 17 CFR 240.19b-4.

regulatory function of NSX.<sup>96</sup> For example, the proposed NSX By-Laws require the NSX Board to consider applicable requirements under Section 6(b) of the Act in connection with the management of the Exchange.<sup>97</sup> In addition, meetings of the NSX Board and of the committees of NSX that pertain to the self-regulatory function of NSX must be closed to persons who are not members of the NSX Board or NSX officers, staff, counsel, or other advisors whose participation is necessary or appropriate to the self-regulatory function of NSX, or representatives of the Commission.<sup>98</sup>

Further, the NSX books and records reflecting confidential information relating to the self-regulatory function of NSX must be kept confidential, must not be used for non-regulatory purposes, and must not be made available to any person other than those directors, officers, and agents of NSX to the extent necessary or appropriate to properly discharge NSX's self-regulatory responsibilities, and the books and records of NSX must be maintained in the U.S.<sup>99</sup> The proposed NSX By-Laws also provide that any revenues received by NSX from fees derived from its regulatory function or regulatory penalties must be applied to fund the legal and regulatory operations of NSX or to pay restitution and disgorgement of funds intended for NSX customers, and may not be used to pay dividends.<sup>100</sup>

<sup>96</sup> See proposed NSX By-Laws, Article X.

<sup>97</sup> See proposed NSX By-Laws, Section 10.1. Section 6(b) of the Act requires, among other things, that the Exchange's rules be designed to protect investors and the public interest. It also requires that the Exchange be so organized that it has the capacity to carry out the purposes of the Act and to enforce compliance by its members with the Act, the rules and regulations promulgated thereunder, and the rules of the Exchange.

<sup>98</sup> See proposed NSX By-Laws, Section 10.2. In addition, members of the Holdings Board who are also not members of the NSX Board and any officers, staff, counsel, or advisors of Holdings who do not hold similar positions with respect to NSX would not be allowed to participate in any meeting of the NSX Board (or any committee of NSX) that pertains to the self-regulatory function of NSX. These requirements and the requirements relating to the confidentiality of records are not, however, designed to prevent the Exchange from sharing with 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 applicable laws, reports from the Commission or others evaluating the Exchange's self-regulatory programs, and information about the trading activities and business strategies of the Exchange's ETP Holders.

<sup>99</sup> See proposed NSX By-Laws, Sections 10.3.

<sup>100</sup> See proposed NSX By-Laws, Section 10.4.

*(vii) Restrictions on Ownership and Transfer*

Although there are no percentage-based restrictions on the ownership of NSX, the proposed NSX Certificate of Incorporation confirms that Holdings will own all of the voting stock of NSX at all times.<sup>101</sup>

*(viii) Changes to Certificate of Incorporation and By-Laws*

Under the proposed NSX Certificate of Incorporation, any change to that document must first be approved by the NSX Board and, if required to be approved or filed with the Commission before it may become effective, cannot take effect until the procedures of the Commission necessary to make it effective have been satisfied.<sup>102</sup>

Similarly, under the proposed NSX By-Laws, any change to that document that is required to be approved by or filed with the Commission before it may become effective cannot take effect until the procedures of the Commission necessary to make it effective have been satisfied.<sup>103</sup> Changes to the NSX By-Laws as proposed may be made by either the stockholders of NSX or the NSX Board, except that certain provisions relating to the NSX Board, and to the voting of NSX stockholders may not be changed without the approval of the stockholder of NSX.<sup>104</sup>

*(c) Other Provisions in the Certificates of Incorporation and By-Laws*

The proposed Holdings By-Laws, Holdings Certificate of Incorporation, NSX Certificate of Incorporation, and NSX By-Laws contain other customary provisions of for-profit corporations, such as provisions relating to corporate offices and corporate purposes;<sup>105</sup> director meetings, voting, removal, compensation and limitation of liability;<sup>106</sup> indemnification of, and insurance for, directors, officers,

<sup>101</sup> See proposed NSX Certificate of Incorporation, Article Fourth.

<sup>102</sup> See proposed NSX Certificate of Incorporation, Article Eleventh.

<sup>103</sup> See proposed NSX Certificate of Incorporation, Article Seventh.

<sup>104</sup> See proposed NSX Certificate of Incorporation, Article Seventh and proposed NSX By-Laws, Section 8.1. In addition, Sections 3.1(b) and 8.2 of the proposed NSX By-Laws permit the NSX Board to amend, repeal, and adopt new Rules of the Exchange.

<sup>105</sup> See proposed NSX Certificate of Incorporation, Articles Second and Third, and proposed NSX By-Laws, Article II; see proposed Holdings Certificate of Incorporation, Articles Second and Third, and proposed Holdings By-Laws, Article I.

<sup>106</sup> See proposed NSX Certificate of Incorporation, Articles Fifth and Eighth, and proposed NSX By-Laws, Article III and Section 7.1; see proposed Holdings Certificate of Incorporation, Articles Sixth and Ninth, and proposed Holdings By-Laws, Article II and Section 7.1.

employees and agents, and advancement of expenses related to defending certain actions;<sup>107</sup> stock certificate procedures;<sup>108</sup> stockholder ownership, including provisions relating to the timing and conduct of meetings, record dates, quorum requirements, proxies, and other matters;<sup>109</sup> and other general provisions.<sup>110</sup>

*(2) National Market System Plans*

NSX currently is a participant in various National Market System ("NMS") plans, including, but not limited to, the Consolidated Tape Association Plan, the Consolidated Quotation System Plan, the Intermarket Trading System Plan, the Intermarket Surveillance Group, and the Reporting Plan for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis ("Nasdaq UTP") Plan. These plans are joint industry plans entered into by SROs for the purpose of addressing last sale reporting, quotation reporting, and intermarket equities trading. Following the completion of the demutualization, NSX, in its continuing role as the SRO, would continue to serve as the voting member of these NMS plans, and a representative of NSX would continue to serve as the Exchange's representative with respect to dealing with these plans.

*(3) Equity Trading Permits; Administrative Changes*

The proposed rule change includes proposed changes to the Rules of the Exchange that are necessary to implement the proposed ETP structure. Following NSX's demutualization, persons and firms who have been qualified for membership pursuant to the Exchange's current Rules and By-Laws and, as a result, have access to the Exchange's trading facilities would receive ETPs entitling them to maintain their trading access to NSX and would be referred to as ETP Holders. References to "members," "member

<sup>107</sup> See proposed NSX By-Laws, Article VII, and proposed Holdings By-Laws, Article VII. In addition, under these provisions, neither corporation is liable for any loss or damage sustained by a current or former member of NSX or ETP Holder relating to such person's use of the facilities of the Exchange or its subsidiaries.

<sup>108</sup> See proposed NSX By-Laws, Article IX, and proposed Holdings By-Laws, Article IX.

<sup>109</sup> See proposed NSX Certificate of Incorporation, Article Ninth, and proposed NSX By-Laws, Article IV; See proposed Holdings Certificate of Incorporation, Article Tenth, and proposed Holdings By-Laws, Article IV.

<sup>110</sup> See, for example, proposed NSX Certificate of Incorporation, Article Tenth, and proposed NSX By-Laws, Article XI; See, e.g., proposed Holdings Certificate of Incorporation, Article Eleventh, and proposed Holdings By-Laws, Article X.

organizations," and similar terms in the current Rules of the Exchange would be replaced with references to "ETP Holders" and similar terms in the NSX Rules.

Each ETP would constitute a revocable license allowing the holder of the permit access to the Exchange's trading facilities in the same manner as previously authorized for NSX's qualified trading members.<sup>111</sup> The demutualization and the implementation of the use of ETPs would not change current NSX member access to the Exchange or their ability to execute transactions. Persons holding ETPs of NSX would be "members" of the Exchange for purposes of the Act and, as noted above, would be characterized as ETP Holders subject to NSX's regulatory jurisdiction.<sup>112</sup> ETP Holders would not have any ownership interest in NSX or in Holdings by virtue of their ETPs.

Provisions of the current By-Laws of NSX relating to members would be moved to a single chapter in the NSX Rules regarding ETP Holders, with certain changes based upon the fact that ETP Holders would be subject to different application processes and would not have to purchase and own a certificate of proprietary membership.<sup>113</sup> Following the demutualization, the Exchange would require persons seeking ETPs to complete appropriate application materials and registration forms, satisfy regulatory requirements, and pay processing charges and application fees as designated by the Exchange. Unlike NSX's current membership application process, ETP Holders would not be required to be approved by NSX's Membership Committee, ETP Holders would be subject to the financial responsibility requirements of Rule 15c3-1 under the Act (but would not be subject to a separate net capital requirement), and ETP applicants would not need to purchase shares of either NSX or Holdings.<sup>114</sup>

Once issued, an ETP would be effective until voluntarily terminated by the ETP Holder or until revoked by NSX

<sup>111</sup> See proposed NSX Rules, Chapter II, Rules 2.1 and 2.2, and proposed NSX Rules, Chapter I, Rule 1.5 (definition of "ETP").

<sup>112</sup> See proposed NSX Rules, Chapter I, Rule 1.5 (definition of "ETP Holder").

<sup>113</sup> Currently, applicants for membership are required to purchase and own a certificate of proprietary membership in order to become a member of NSX. See Article II, Section 5.2 of the current By-Laws of NSX. In connection with the demutualization, all outstanding certificates of proprietary membership would be cancelled and no other certificates of proprietary membership would be issued by NSX following the demutualization.

<sup>114</sup> See proposed NSX Rules, Chapter II.

for, among other things, noncompliance with the NSX Rules.<sup>115</sup> NSX would have the ability to revoke an ETP for the same reasons that it is currently entitled to revoke a membership.<sup>116</sup> An ETP could not be sold, leased, or otherwise transferred.<sup>117</sup> There would be nominal processing charges and application fees relating to the issuance of ETPs. In addition, ETP Holders would be subject to such fees as are designated by NSX or set forth in the NSX Rules.<sup>118</sup>

Certain other provisions of the current By-Laws of NSX respecting listing standards and other matters not relating to the Exchange's corporate governance would be moved to the NSX Rules. The provisions contained in Article IV of the current By-Laws of NSX (relating to Securities Listed on the Exchange) would be moved to a new Chapter XV of the NSX Rules. In addition, current Rules 13.6 and 13.7 (relating to Listing Standards) would be moved to this new Chapter XV of the NSX Rules.<sup>119</sup>

Finally, new NSX Rule 2.10 would prohibit, without prior Commission approval, either (i) NSX or any NSX affiliate from directly or indirectly acquiring or maintaining an ownership interest in an ETP Holder, or (ii) an ETP Holder being or becoming an affiliate of NSX or any affiliate of NSX. Under proposed Rule 2.10, the term "affiliate" has the meaning specified in Rule 12b-2 of the Act. Proposed Rule 2.10 would not prohibit any ETP Holder or its affiliate from acquiring or holding an equity interest in Holdings that is permitted by the ownership and voting limitations in the Holdings Certificate of Incorporation, and would not prohibit an ETP Holder or an officer, director, manager, managing member, partner, or affiliate of an ETP Holder being or becoming an ETP Holder Director or an At-Large Director on the NSX Board, or a member of the Holdings Board.<sup>120</sup>

### III. Summary of Comments

The Council of Institutional Investors ("CII") wrote to express its concern over the potential conflict of interest that could arise when an exchange is responsible for regulating its members

<sup>115</sup> See proposed NSX Rules, Chapter II, Rules 2.6 and 2.7.

<sup>116</sup> See proposed NSX Rules, Chapter II, Rule 2.6.

<sup>117</sup> See proposed NSX Rules, Chapter II, Rule 2.8.

<sup>118</sup> See, generally proposed NSX Rules, Chapter XI, Rule 11.10(B).

<sup>119</sup> In addition, NSX also proposes to move to the NSX Rules, and make technical changes to, certain provisions under the current By-Laws of NSX relating to Exchange Membership (Article II), Dues, Assessments and Other Charges (Article III), Securities Listed on the Exchange (Article IV), Commissions (Article XI) and Off-Exchange Transactions (Article XII).

<sup>120</sup> See Amendment No. 1, *supra* note 3.

and at the same time operating as a for-profit entity. The CII believes that this conflict of interest is "untenable" and has created problems in the past and will continue to create problems in the future.<sup>121</sup> To address this conflict, the CII recommends that: (1) Regulatory operations of NSX should be made independent of the Exchange and adequately funded; and (2) listing standard requirements should be made a regulatory responsibility rather than the responsibility of the Exchange.<sup>122</sup>

NSX responded to the CII comment letter on June 5, 2006.<sup>123</sup> The Exchange asserted that the two concerns raised by CII have already been addressed by the Exchange prior to the filing of this proposed rule change. The NSX noted that it created a Regulatory Oversight Committee ("ROC") that is charged with overseeing all regulatory functions and responsibilities, including recommending an adequate operating budget for the Exchange's regulatory functions. The Exchange also created the position of Chief Regulatory Officer who reports directly to the ROC and not the Chief Executive Officer. This structure separates the regulatory operations from the Exchange. NSX stated that this structure assured that listing standard requirements are a regulatory rather than an Exchange responsibility as they are the function of the Regulatory Services Division.

### IV. Discussion

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>124</sup> In particular, the Commission finds that the proposed rule change, as amended, is consistent with Section 6(b)(1) of the Act,<sup>125</sup> 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, as amended, is consistent with Section 6(b)(3) of the Act,<sup>126</sup> which requires that the rules of a national securities exchange assure the fair representation of its members in the selection of its

<sup>121</sup> See CII Letter, *supra* note 6.

<sup>122</sup> CII Letter at 1.

<sup>123</sup> See NSX Response, *supra* note 7.

<sup>124</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>125</sup> 15 U.S.C. 78f(b)(1).

<sup>126</sup> 15 U.S.C. 78f(b)(3).

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, as amended, is consistent with Section 6(b)(5) of the Act,<sup>127</sup> 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. Holdings as Sole Shareholder

Following completion of the demutualization, Holdings would be the sole shareholder of NSX. Section 19(b) of the Act<sup>128</sup> and Rule 19b-4 thereunder<sup>129</sup> require an SRO to file proposed rule changes with the Commission. Although Holdings is not an SRO, certain provisions of its Certificate of Incorporation and By-Laws may be rules of an exchange<sup>130</sup> if they are the stated policies, practices, or interpretations, as defined in Rule 19b-4 of the Act, of NSX. Any proposed rule or any proposed change in, addition to, or deletion from, the rules of an exchange must be filed with the Commission pursuant to Section 19(b) of the Act and Rule 19b-4 thereunder. Accordingly, NSX has filed the Holdings Certificate of Incorporation Holdings By-Laws with the Commission. If Holdings decides to change its Certificate of Incorporation or By-Laws, it must submit such changes to the NSX Board so that it can determine if the changes must be filed with, and approved by, the Commission.<sup>131</sup> The Commission believes that these provisions would assist NSX in fulfilling its self-regulatory obligations and in administrating and complying with the requirements under the Act.

<sup>127</sup> 15 U.S.C. 78f(b)(5).

<sup>128</sup> 15 U.S.C. 78s(b).

<sup>129</sup> 17 CFR 240.19b-4.

<sup>130</sup> Section 3(a)(27) of the Act defines the rules of an exchange to be the constitution, articles of incorporation, By-Laws, and rules, or instruments corresponding to the foregoing, of an exchange, and such stated policies, practices, or interpretations of such exchange as the Commission, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules of such exchange. 15 U.S.C. 78c(a)(27).

<sup>131</sup> See proposed Holdings Certificate of Incorporation, Article Twelfth and Holdings By-Laws Article VIII.

### B. Changes in Control of NSX

The Commission believes that the restrictions in the Holdings Certificate of Incorporation on direct and indirect changes in control of Holdings are sufficient to enable NSX to carry out its self-regulatory responsibilities and to enable the Commission to fulfill its responsibilities under the Act.<sup>132</sup>

Specifically, as proposed, NSX would be wholly-owned subsidiary of Holdings, *i.e.*, Holdings would own all of the shares of NSX. The NSX Certificate of Incorporation identifies this ownership structure.<sup>133</sup> Any changes to the NSX Certificate of Incorporation, including any change to the provision that identifies NSX shareholders, must be filed with, and approved by, the Commission pursuant to Section 19(b) of the Act.<sup>134</sup>

In addition, the Holdings Certificate of Incorporation imposes limitations on direct and indirect changes in control of Holdings through voting and ownership limitations placed on the capital stock of Holdings and allows Holdings to monitor potential changes in control through a notification requirement once a threshold percentage of ownership of capital stock is reached.<sup>135</sup> Specifically, the Holdings Certificate of Incorporation prohibits any Person, either alone or together with its Related Persons, from voting or giving a proxy or consent with respect to shares representing more than 20% of the voting power of the issued and outstanding capital stock of Holdings.<sup>136</sup> This restriction would not

apply to the Class B or Class C common stock and, as to the Class A common stock owned by Persons other than ETP Holders and their Related Persons, may be waived by Holdings Board pursuant to a resolution adopted by the Holdings Board.<sup>137</sup> Before adopting such resolution, however, the Holdings Board must determine that, among other things, the waiver of the voting limitation would not impair the ability of NSX to carry out its functions and responsibilities under the Act and the rules and regulations promulgated thereunder, and would not impair the Commission's ability to enforce the Act and the rules and regulations promulgated thereunder.<sup>138</sup> In addition, the Holdings Board also must determine that a Person and its Related Persons that would vote more than 20% of the outstanding stock of Holdings are not subject to an applicable "statutory disqualification" (within the meaning of Section 3(a)(39) of the Act).<sup>139</sup> Finally, any resolution of the Holdings Board that would permit a Person to vote more than 20% of the outstanding stock of Holdings must be filed with and approved by the Commission before it becomes effective.<sup>140</sup>

Furthermore, the Holdings Certificate of Incorporation limits the right of any Person, either alone or together with its Related Persons, to enter into any agreement with respect to the withholding of any vote or proxy where the effect of the agreement would be to enable any person or group to obtain more than 20% of the outstanding voting power.<sup>141</sup> The Holdings Certificate of Incorporation also restricts the ability of any Person, either alone or together with its Related Persons, from owning, directly or indirectly, shares constituting more than 40% of any class of the outstanding shares of capital stock of Holdings.<sup>142</sup>

If any shareholder votes, sells, transfers, assigns, or pledges any shares in violation of the voting and ownership limitations, Holdings would treat those shares as owned by the transferor for all purposes, including, without limitation, voting, payment of dividends, and

distributions.<sup>143</sup> In addition, if any shareholder votes, sells, transfers, assigns, or pledges any shares in violation of the voting and ownership limitations, Holdings has the right to redeem those shares at a price equal to the par value thereof, upon the approval of the Holdings Board.<sup>144</sup>

NSX has also proposed to require Holdings shareholders that own, of record or beneficially, five percent or more of the then outstanding shares to give the Holdings Board written notice of such ownership. This notice should enable Holdings to monitor the ownership of its stock to ensure that no limitation is reached.<sup>145</sup>

The Holdings Certificate of Incorporation also provides that no Person, either alone or together with its Related Persons, who is a ETP Holder may own, directly or indirectly, shares constituting more than 20% of any class of capital stock of Holdings.<sup>146</sup> However, this ownership restriction would not apply to any ETP Holder with respect to shares of Class C common stock of Holdings (which is not entitled to the right to vote) issued to the ETP Holder in connection with, and from the date of, the demutualization of NSX so long as the ETP Holder becomes compliant with the ownership limitation promptly after such issuance.<sup>147</sup>

The Commission finds that the limitation on ownership of shares of Holdings by NSX ETP Holders is consistent with the Act. Under the member-owned exchange model, a member who trades securities through the facilities of an exchange can have an ownership interest in the exchange. A regulatory concern can arise if a member's interest becomes so large as to cast doubt on whether the exchange can fairly and objectively exercise its self-regulatory responsibilities with respect

<sup>132</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (d).

<sup>133</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (e).

<sup>134</sup> The Commission believes that NSX Holdings should disclose periodically, or otherwise make available upon request, information regarding the number of outstanding shares of its capital stock, so that persons that own stock of Holdings 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 or require that person to provide written notice under the Article Fifth, paragraph (c) of the Holdings Certificate of Incorporation.

<sup>135</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(ii)(B). Unlike the 40% ownership and 20% voting limitations discussed above, the NSX Holdings Board may not waive the 20% ownership limitation applicable to NSX trading permit holders.

<sup>136</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(ii)(C); see also proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (a) for definitions of "Person" and "Related Person."

<sup>137</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraphs (b)(iii)(A) and (B). See Amendment No. 1, *supra* note 3.

<sup>138</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(iii)(B).

<sup>139</sup> 15 U.S.C. 78c(a)(39); see proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(iv).

<sup>140</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(iii)(B).

<sup>141</sup> See proposed NSX Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(ii)(C).

<sup>142</sup> See proposed Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(ii)(A).

to that member. For example, a member that directly or indirectly controls an exchange might be tempted to exercise that controlling influence by directing the exchange to refrain from diligently monitoring 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 diligently monitor and conduct surveillance of trading conduct and to enforce its rules and the federal securities laws against a member that the exchange relies on for a large source of capital. The Commission believes that the proposed limitation would help mitigate the conflicts of interest that could occur if a member were to control a significant stake in the Exchange through ownership in shares in the Exchange's parent company and are necessary and appropriate to help ensure that the Exchange can effectively carry out its statutory obligations under Section 6(b) of the Act.<sup>148</sup>

#### C. Regulatory Jurisdiction Over Holdings

The Commission believes that the terms of Holdings By-Laws provide the Commission with sufficient regulatory jurisdiction over the controlling parties of the Exchange to carry out its oversight responsibilities under the Act. The Holdings By-Laws provide that, to the extent that they are related to the activities of NSX, the books, records, premises, officers, directors, agents, and employees of Holdings are deemed to be the books, records, premises, officers, directors, agents, and employees of NSX for purposes of and subject to oversight pursuant to the Act.<sup>149</sup> This provision would enable the Commission to exercise its authority under Section 19(h)(4) of the Act<sup>150</sup> with respect to officers and directors of Holdings, because all such officers and directors, to the extent that they are acting on matters related to NSX activities, would be deemed to be officers and directors of NSX. Furthermore, the books and records of Holdings, to the extent that they are related to the activities of NSX, are subject to the Commission's

<sup>148</sup> 15 U.S.C. 78f(b).

<sup>149</sup> See proposed Holdings By-Laws, Article III, Section 3.3.

<sup>150</sup> 15 U.S.C. 78s(h)(4). Section 19(h)(4) authorizes the Commission, by order, to remove from office or censure any officer or director of a national securities exchange if it finds, after notice and an opportunity for hearing, that such officer or director: (1) has willfully violated any provision of the Act or the rules and regulations thereunder, or the rules of a national securities exchange; (2) willfully abused his or her authority; or (3) without reasonable justification or excuse, has failed to enforce compliance with any such provision by a member or person associated with a member of the national securities exchange.

examination authority under Section 17(b)(1) of the Act,<sup>151</sup> as these records would be deemed to be the records of NSX itself.

In addition, pursuant to the Holdings By-Laws, Holdings officers, directors, employees, and agents, by virtue of their acceptance of such position, are deemed to irrevocably submit to the jurisdiction of the U.S. Federal courts, the Commission, and NSX for the purposes of any suit, action, or proceeding pursuant to the U.S. federal securities laws and the rules and regulations thereunder, arising out of, or relating to, the activities of the Exchange.<sup>152</sup> Moreover, Holdings and such officers, directors, employees, and agents, by virtue of their acceptance of any such position, are deemed to waive and agree not to assert by way of motion as a defense or otherwise in any such suit, action, or proceeding any claims that it or they are not personally subject to the jurisdiction of the U.S. Federal courts, the Commission, or NSX, that the suit, action, or proceeding is an inconvenient forum, or that the venue of the suit, action, or proceeding is improper, or that the subject matter of that suit, action, or proceeding may not be enforced in or by such courts or agency.<sup>153</sup> Finally, the Holdings By-Laws provide that the officers, directors, employees, and agents of Holdings, by virtue of their acceptance of such position, are deemed to agree to cooperate with the Commission and NSX in respect of the Commission's oversight responsibilities regarding NSX and the self-regulatory functions and responsibilities of NSX.<sup>154</sup>

The Commission also notes that, even in the absence of these provisions of the Holdings By-Laws, Section 20(a) of the Act<sup>155</sup> provides that any person with a controlling interest in NSX would be jointly and severally liable with and to the same extent that NSX is liable under any provision of the Act, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. In addition, Section 20(e) of the Act<sup>156</sup> creates aiding and abetting liability for any person who knowingly provides substantial assistance to another person in violation of any provision of the Act or rule thereunder, and Section 21C of the

Act<sup>157</sup> authorizes the Commission to enter a cease-and-desist order against any person who has been "a cause of" a violation of any provision of the Act through an act or omission that the person knew or should have known would contribute to the violation. The Commission believes that, taken together, these provisions grant the Commission sufficient jurisdictional authority over the controlling persons of NSX. Moreover, NSX is required to enforce compliance with these provisions because they are "rules of the exchange" within the meaning of Section 3(a)(27) of the Act.<sup>158</sup> A failure on the part of NSX to enforce its rules could result in suspension or revocation of NSX's registration under Section 19(h)(1) of the Act.<sup>159</sup>

#### D. Self-Regulatory Function of NSX

Following the demutualization, the rules and By-Laws of NSX would reflect its status as a wholly-owned subsidiary of Holdings, under management of the NSX Board and its designated officers and with self-regulatory obligations pursuant to NSX's registration as a national securities exchange under Section 6 of the Act.<sup>160</sup>

As the sole shareholder of NSX, the Commission believes that Holdings' activities with respect to its ownership of NSX must be consistent with NSX's obligations under the Act. The Commission recognizes that the ownership structure of for-profit exchanges could present potential conflicts of interest.<sup>161</sup> However, the Commission believes that NSX has taken steps to address this conflict.<sup>162</sup> Under the Holdings By-Laws, the Holdings Board and the officers, employees, and agents of Holdings must give due regard to the preservation of the independence of the self-regulatory function of NSX and to its obligations to investors and the general public and not take any actions that would interfere with the effectuation of any decisions by the NSX Board relating to its regulatory functions or the structure of the market it regulates or which would interfere with the ability of NSX to carry out its responsibilities under the Act.<sup>163</sup> In addition, all books and records of NSX reflecting confidential information pertaining to its self-regulatory function (including but not limited to disciplinary matters, trading data,

<sup>151</sup> 15 U.S.C. 78q(b)(1).

<sup>152</sup> See proposed NSX Holdings By-Laws, Article III, Section 3.5.

<sup>153</sup> See proposed NSX Holdings By-Laws, Article III, Section 3.5.

<sup>154</sup> See proposed NSX Holdings By-Laws, Article III, Section 3.4.

<sup>155</sup> 15 U.S.C. 78t(a).

<sup>156</sup> 15 U.S.C. 78t(e).

<sup>157</sup> 15 U.S.C. 78u-3.

<sup>158</sup> 15 U.S.C. 78c(a)(27).

<sup>159</sup> 15 U.S.C. 78s(h)(1).

<sup>160</sup> See 15 U.S.C. 78c(a)(26).

<sup>161</sup> See CII Letter. See also *supra* note 132.

<sup>162</sup> See also *supra*, note 132.

<sup>163</sup> See proposed NSX Holdings By-Laws, Article III, Section 3.1.

trading practices, and audit information) which come into the possession of Holdings, and the information contained therein, must be retained in confidence by Holdings and its directors, officers, employees, and agents and must not be used for any non-regulatory purposes.<sup>164</sup> The Commission believes that these provisions, which are designed to acknowledge the need to maintain the independence of the self-regulatory role of NSX following the demutualization and protect from improper use information pertaining to its self-regulatory function, are appropriate.

Further, the Commission notes that the NSX By-Laws expressly require that the NSX Board consider applicable requirements for registration as a national securities exchange under Section 6(b) of the Act,<sup>165</sup> including the requirement that the rules of the Exchange be designed to protect investors and the public interest and the requirement that the Exchange 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 members with the provisions of the Act, the rules and regulations thereunder and with the rules of the Exchange.<sup>166</sup> In the Commission's view, this provision should serve to remind the NSX Board that it must consider the interests of the Exchange's constituents and the requirements of the Act when taking action on behalf of the Exchange.

#### E. Fair Representation

Section 6(b)(3) of the Act<sup>167</sup> 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. In addition, Section 6(b)(1) of the Act<sup>168</sup> requires that an exchange be so organized and have the capacity to be able to carry out the purposes of the Act.

After the demutualization, the NSX Board would initially consist of 13 directors. The NSX Board would be initially comprised of the CEO of NSX, 3 ETP Holder Directors,<sup>169</sup> 7

<sup>164</sup> See proposed NSX Holdings By-Laws, Article III, Section 3.2.

<sup>165</sup> 15 U.S.C. 78f(b).

<sup>166</sup> See proposed NSX By-Laws, Article X, Section 3.1.

<sup>167</sup> 15 U.S.C. 78f(b)(3).

<sup>168</sup> 15 U.S.C. 78f(b)(1).

<sup>169</sup> An ETP Holder Director is defined under the proposed NSX By-Laws as a director who is an ETP Holder or a director, officer, managing member or

Independent Directors,<sup>170</sup> and 2 directors who are executive officers of CBOE, its members,<sup>171</sup> or executive officers of CBOE member organizations.<sup>172</sup> Under the proposed rule change, the NSX Board may by resolution increase its size to up to 20 directors. Directors added to the NSX Board to fill these new director positions would be (i) Independent Directors, to the extent necessary for the NSX Board to include at least 50% Independent Directors; (ii) ETP Holder Directors, to the extent necessary for the NSX Board to include at least 20% ETP Holder Directors; and (iii) persons who do not qualify as Independent Directors ("At-Large Directors"), for the remainder of the positions added to the NSX Board that are not filled with Independent Directors or ETP Holder Directors pursuant to clauses (i) and (ii) above. At all times, the NSX Board must include the CEO of NSX, at least 50% Independent Directors and 3 ETP Holder Directors (or such greater number of ETP Holder Directors as is necessary to comprise at least 20% of the NSX Board).<sup>173</sup>

Because NSX ETP Holders would not be shareholders of NSX, they would not directly elect members of the NSX Board. As the sole shareholder of NSX, Holdings would have the sole right and obligation to vote for the director nominees nominated by the NSX Governance and Nominating Committee. The NSX By-Laws, however, establish a procedure that would allow ETP Holders to be involved in the selection of candidates to fill ETP Director positions on the NSX Board.<sup>174</sup> Each participant would have one vote

partner of an entity that is an ETP Holder. See proposed NSX By-Laws, Section 1.1(E)(2).

<sup>170</sup> An Independent Director is defined under the proposed NSX By-Laws as a member of the NSX Board that the NSX Board has determined to have no material relationship with NSX or any affiliate of NSX, or any ETP Holder or any affiliate of any such ETP Holder, other than as a member of the NSX Board. See proposed NSX By-Laws, Section 1.1(I)(1). The Commission notes that NSX has stated that at least one Independent Director will be representative of investors; *see* Amendment No. 1, *supra* note 3.

<sup>171</sup> A CBOE member is defined under the proposed NSX By-Laws as an individual CBOE member or a CBOE member organization that is a regular member or special member of CBOE (as such terms are described in the Constitution of the CBOE), as such CBOE members may exist from time to time. *See* proposed NSX By-Laws, Section 1.1(C)(2). *See also supra* subsection II.b.(1)(b)(ii) for a discussion of CBOE's equity interest in the Exchange.

<sup>172</sup> *See* proposed NSX By-Laws, Section 3.2(a). *See also supra* note 20.

<sup>173</sup> *See* proposed NSX By-Laws, Section 3.2(b); *see* Amendment No. 1, *supra* note 3.

<sup>174</sup> *See* proposed NSX By-Laws, Section 3.5; *see* discussion of nominating process in Discussion section *supra*.

per trading permit with respect to each Participant Director position to be filled.<sup>175</sup>

The ETP Holder Director Nominating Committee, comprised entirely of ETP Holders Directors and/or ETP Holder representatives would consult with the Governance and Nominating Committee, the Chairman of the Board and the Chief Executive Officer, and solicit comments from the ETP Holders and submit a list of candidates for election to the position of ETP Holder Director to the Governance and Nominating Committee. ETP Holder may petition in a timely manner to add additional nominees provided that the petition is signed by 10 or more percent of all ETP Holders. The ETP Holder Director candidates receiving the most votes from ETP Holders shall be the directors elected to the NSX Board as ETP Directors by NSX Holdings. If no timely petitions are received, the slate of candidates put forth by the ETP Holder Director Nominating Committee shall be the ETP Directors elected to the NSX Board by NSX Holdings.<sup>176</sup>

The Commission finds that the requirement that at least one-half of the directors of the NSX Board be Independent Directors is consistent with Sections 6(b)(1) and 6(b)(3) of the Act, which requires that one or more directors be representative of issuers and investors. The Commission also finds that the requirement that at least 20% of the directors be ETP Directors and the manner in which such directors would be nominated and elected, satisfies the fair representation requirements in Section 6(b)(3) of the Act. The Commission notes, however, that after the demutualization trading privileges would be separated from corporate ownership of NSX and would be available exclusively through trading permits. Therefore, the Commission expects that trading permits would not be issued in a manner that would undermine or circumvent the requirement in Section 6(b)(3) of the Act for fair representation of members. The Commission also notes that participants would retain a voice in the administration of the affairs of NSX following the demutualization, including rulemaking and the disciplinary process, through participants' participation on the NSX Board.

<sup>175</sup> Under Section 3.5(e) of the proposed NSX By-Laws, each ETP Holder, regardless of its affiliation with other ETP Holders, will have one vote with respect to each ETP Holder Director position to be filled, but may not cast such votes cumulatively.

<sup>176</sup> *See* proposed NSX By-Laws, Sections 3.5 and 5.1.

Finally, the Commission notes that it is in the process of reviewing a range of governance issues relating to SROs, including possible steps to strengthen the framework for the governance of SROs and ways to improve the transparency of the governance procedures of all SROs and has proposed rules in furtherance of this goal.<sup>177</sup> Depending on the results of the proposed rules, NSX may be required to make further changes to strengthen its governance structure. The Commission also believes that the NSX Board should continue to monitor and evaluate its governance structure and process on an ongoing basis and propose further changes as appropriate.

#### F. Dividends

With the demutualization, the holders of capital stock of NSX, in this case Holdings, would have the dividend and other distribution rights of a shareholder in a Delaware stock corporation. The NSX By-Laws allow the NSX Board to declare dividends.<sup>178</sup> However, the NSX By-Laws further provide that any revenues received by NSX from regulatory fees or regulatory penalties would be applied to fund the legal and regulatory operations, including the surveillance and enforcement activities, of NSX and would not be used to pay dividends.<sup>179</sup> This limitation would preclude NSX from providing dividends derived from regulatory fees or penalties to the sole shareholder of NSX, *i.e.*, Holdings. As a result, Holdings would not be able to provide dividends derived from regulatory fees or penalties belonging to NSX to the shareholders of Holdings. The Commission finds that the prohibition on the use of regulatory fees or penalties to fund dividends is consistent with Section 6(b)(1) of the Act because it would ensure that the regulatory authority of NSX is not used improperly to benefit Holdings and its shareholders.

#### G. Other Changes

Following the demutualization, NSX would continue to serve as a voting member of various NMS plans addressing last sale reporting, quotation reporting, and intermarket equities trading. In addition, following the demutualization, NSX will put into effect certain rule changes necessary to implement its proposed ETP structure, including referring to persons and firms who are currently qualified for

Exchange membership under its current Rules and By-Laws as ETP Holders, entitling them to maintain their trading access to the Exchange; corresponding changes to references in the Exchange's Rules to "members," "member organizations," and similar terms would also be made. ETP Holders would have revocable licenses allowing them to access the Exchange's trading facilities in the same manner currently authorized for qualified trading members. In addition, ETP Holders would be "members" of the Exchange for purposes of the Act and would be subject to NSX's regulatory jurisdiction and oversight. However, ETP Holders would not have any ownership interest in the Exchange or in Holdings by virtue of their ETPs. The Exchange would subject potential ETP Holders to an application process, and ETP Holders would be subject to the financial responsibility requirements of Rule 15c3-1 under the Act. ETPs would be effective until voluntarily terminated by the ETP Holder or until revoked by the Exchange. ETPs could not be sold, leased, or otherwise transferred.

As part of the demutualization, the Exchange would move certain non-corporate governance-related provisions currently in the NSX By-Laws to the NSX Rules. Finally, new NSX Rule 2.10 would prohibit, without prior Commission approval, either (i) NSX or any NSX affiliate from directly or indirectly acquiring or maintaining an ownership interest in an ETP Holder, or (ii) an ETP Holder being or becoming an affiliate of NSX or any affiliate of NSX. The term "affiliate" would have the meaning specified in Rule 12b-2 of the Act. Proposed Rule 2.10 would not prohibit any ETP Holder or its affiliate from acquiring or holding an equity interest in Holdings that is permitted by the ownership and voting limitations in the Holdings Certificate of Incorporation, and would not prohibit an ETP Holder or an officer, director, manager, managing member, partner, or affiliate of an ETP Holder being or becoming an ETP Holder Director or an At-Large Director on the NSX Board, or a member of the Holdings Board.

The Commission finds that these proposed rule changes are consistent with the requirements of the Acts and the rules and regulations thereunder. In particular, the Commission finds that the proposed rule changes relating to ETP Holders and their affiliates are consistent with Section 6(b)(1) of the Act,<sup>180</sup> which requires a national securities exchange to be so organized

and have the capacity to carry out the purposes of the Act.

#### V. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>181</sup> that the proposed rule change (SR-NSX-2006-03), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>182</sup>

**J. Lynn Taylor,**

*Assistant Secretary.*

[FR Doc. E6-9354 Filed 6-14-06; 8:45 am]

**BILLING CODE 8010-01-P**

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-53958; File No. SR-NYSE-2006-34]

### Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change To Delete an Obsolete Provision in Its Minor Rule Violation Plan

June 8, 2006.

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 June 2, 2006, the New York Stock Exchange LLC ("NYSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and approving the proposal on an accelerated basis.

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

The Exchange is proposing to amend NYSE Rule 476A (Imposition of Fines for Minor Violation(s) of Rules) to reflect the deletion of NYSE Rule 124(A). The text of the proposed rule change is available on the Exchange's Web site (<http://www.nyse.com>), at the Exchange's principal office, and at the Commission's Public Reference Room.

<sup>177</sup> See Proposed Rulemaking, *supra* note 134.

<sup>178</sup> See proposed NSX By-Laws, Section 11.2.

<sup>179</sup> For purposes of this provision, regulatory penalties include restitution and disgorgement of funds intended for customers. See proposed NSX By-Laws, Section 10.4.

<sup>180</sup> 15 U.S.C. 78s(b)(2).

<sup>181</sup> 17 CFR 200.30-3(a)(12).

<sup>182</sup> 15 U.S.C. 78s(b)(1).

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

<sup>180</sup> 15 U.S.C. 78f(b)(1).