

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- 51149, File No. SR-CHX-2004-26)

February 8, 2005

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 3 by the Chicago Stock Exchange, Inc. Relating to the Demutualization of the Chicago Stock Exchange, Inc.

I. Introduction

On November 24, 2004, the Chicago Stock Exchange, Inc. (“CHX” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² a proposed rule change to effect the demutualization of CHX. CHX filed Amendment No. 1 to the proposal on December 15, 2004.³ CHX filed Amendment Nos. 2 and 3 to the proposal on January 28, 2005.⁴

The proposed rule change and Amendment No. 1 were published for comment in the Federal Register on December 28, 2004.⁵ The Commission received no comment letters regarding the proposal and Amendment No. 1. This order approves the proposed rule change, as

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ In Amendment No. 1, CHX revises several references in the original proposal to reflect the November 2004 vote of CHX's members to approve the demutualization.

⁴ Amendment No. 3 replaced and superseded Amendment No. 2 in its entirety. In Amendment No. 3, CHX revises the proposal to: (1) indicate that the staff of CHX will present to the Board of Directors of CHX Holdings for its approval a proposed new Bylaws provision stating that CHX Holdings will take such action as is necessary to insure that its officers, directors, and employees consent to the applicability of Article III, Section 3, and Article III, Section 5 of the CHX Holdings Bylaws with respect to CHX-related activities; (2) confirm CHX's continuing participation in various national market system plans following the demutualization; (3) correct a typographical error in the numbering of the articles of the CHX Bylaws; and (4) clarify language regarding the admission of persons to membership.

⁵ See Securities Exchange Act Release No. 50892 (December 20, 2004), 69 FR 77796.

amended. In addition, the Commission is publishing notice to solicit comments on, and is simultaneously approving, on an accelerated basis, Amendment No. 3.

II. Description of Proposed Rule Change

Currently, CHX is a non-stock, not-for-profit Delaware corporation. CHX proposes to demutualize by reorganizing as a Delaware for-profit stock corporation that will be a subsidiary of a new Delaware for-profit stock holding company, CHX Holdings, Inc. ("CHX Holdings").⁶ CHX will continue to operate as a national securities exchange registered under Section 6 of the Act⁷ and will continue to have self-regulatory responsibilities over its members. CHX will have its own Board of Directors that will manage CHX's business and affairs.

On the effective date of the demutualization, each person or entity that owns a membership in CHX will receive 1,000 shares of common stock of CHX Holdings for each membership that the person or entity owns. All of the issued and outstanding stock of CHX Holdings (450,000 shares of common stock) initially will be owned by the persons or entities that owned memberships in the Exchange.⁸ Following the demutualization, persons and entities who have been qualified for membership under Articles 1, 2, or 3 of the Exchange's current rules and, as a result, have access to the Exchange's trading floor and other facilities ("qualified

⁶ To accomplish the demutualization, CHX proposes to establish two new Delaware stock for-profit corporations: CHX Holdings, a direct and wholly-owned subsidiary of CHX; and CHX Merger Sub, Inc. ("CHX Merger Sub"), a direct and wholly-owned subsidiary of CHX Holdings. Pursuant to an agreement and plan of merger, CHX Merger Sub will merge with and into CHX, with CHX surviving the merger as a Delaware for-profit stock corporation that is a direct and wholly-owned subsidiary of CHX Holdings.

⁷ 15 U.S.C. 78f. The proposed rule change, as amended, includes: (1) CHX's revised rules; (2) CHX's revised Certificate of Incorporation; (3) CHX's revised Bylaws; (4) the Certificate of Incorporation for CHX Holdings; and (5) the Bylaws of CHX Holdings.

⁸ CHX Holdings will have an additional 300,000 shares of authorized, but not issued, common stock and 25,000 shares of authorized, but not issued, preferred stock. See CHX Holdings Certificate of Incorporation, Article Fourth.

trading members”) will separately receive CHX trading permits entitling them to maintain their trading access to CHX.

Shares of CHX Holdings common stock and CHX trading permits will not be tied together. As a result, following the demutualization, former CHX members will be able to sell the shares of CHX Holdings common stock they receive in exchange for their CHX memberships, subject to the applicable restrictions described below, while retaining the ability to trade and operate on CHX pursuant to their CHX trading permits. Any other person who satisfies the regulatory requirements set forth in CHX’s rules also will be able to obtain a CHX trading permit without regard to whether such person is a shareholder of CHX Holdings. Persons who hold trading permits in the demutualized Exchange will be called “participants” or “participant firms.”

CHX’s proposal included the CHX Holdings Certificate of Incorporation and Bylaws; proposed changes to the CHX Certificate of Incorporation and Bylaws that reflect the proposed changes in its corporate form; proposed governance changes that will, among other things, reduce the size of the CHX Board and make certain changes relating to CHX committees. In addition, CHX proposed changes to its membership rule that are necessary to implement the proposed trading permit structure.⁹ Specifically, CHX proposed to replace references to "members," "member organizations," and "member firms" with references to "participants" and "participant firms." CHX also proposed to delete references to sales of memberships and consolidate the current separate articles relating to members into a single article regarding

⁹ CHX also proposed to delete the following rules relating to events that have occurred or to programs that CHX no longer offers: Article IB, "E-Session Trading Privileges;" Article XI, Rules 11, "Mandatory Year 2000 Testing," and 12, "Mandatory Decimal Pricing Testing;" and Article XIII, Rule 4, "Advertisements, Market Sales Literature Relating to Options and Communications to Customers."

participant firms. In its filing, CHX represented that it was not proposing to change its existing operational and trading structure.

A. Corporate Structure

1. CHX Holdings

CHX Holdings will be the parent company and sole shareholder of CHX. As sole shareholder of CHX, CHX Holdings will have the right to elect the Board of Directors of CHX and collect dividends, subject to certain provisions in the CHX rules that reflect regulatory requirements under the federal securities laws. The Certificate of Incorporation and the Bylaws of CHX Holdings will govern the activities of CHX Holdings.

(a) CHX Holdings Board of Directors

The business and affairs of CHX Holdings will be managed by its Board of Directors ("CHX Holdings Board"). The CHX Holdings Board will consist of between 10 and 16 persons, as determined by the CHX Holdings Board, including the Chief Executive Officer ("CEO") of CHX Holdings.¹⁰ Initially, the CHX Holdings Board will have 14 directors, who will be selected by the Chairman, Vice Chairman, and CEO of CHX from among the persons currently serving on the Exchange's Board of Governors.¹¹

The CHX Holdings Board will elect its Chairman from among the directors on the CHX Holdings Board.¹² The Chairman of the CHX Holdings Board may serve as the CEO of CHX Holdings but may hold no other office in CHX Holdings.¹³ The Chairman of the CHX Holdings Board will nominate the Vice Chairman of the CHX Holdings Board, and the CHX Holdings

¹⁰ See CHX Holdings Certificate of Incorporation, Article Sixth, Sections (b) and (c), and CHX Holdings Bylaws, Article II, Section 2.

¹¹ See CHX Holdings Certificate of Incorporation, Article Sixth, Section (g).

¹² See CHX Holdings Bylaws, Article II, Section 4.

¹³ See CHX Holdings Bylaws, Article II, Section 4.

Board will elect the Vice Chairman by majority vote.¹⁴ The Vice Chairman may hold no other office in CHX Holdings.¹⁵ Neither the Chairman nor the Vice Chairman of CHX Holdings will be subject to any limit on the number of terms that he or she may serve.

Each year, the Nominating and Governance Committee of CHX Holdings will nominate directors for the class of directors standing for election at the CHX Holdings annual meeting of shareholders.¹⁶ Each CHX Holdings shareholder will be entitled to one vote for each share of stock he or she owns, absent a provision in the CHX Holdings Certificate of Incorporation fixing or denying voting rights.¹⁷ At each annual meeting of the shareholders of CHX Holdings at which a quorum is present, the individuals receiving a plurality of the votes cast will be elected directors of CHX Holdings.¹⁸

(b) Committees of CHX Holdings

CHX Holdings will have an Executive Committee, a Nominating and Governance Committee, an Audit Committee, a Compensation Committee, and any other committees that the CHX Holdings Board establishes.¹⁹ The CHX Holdings Board will appoint the CHX Holdings Nominating and Governance Committee, which will consist of six directors.²⁰ The Chairman and Vice Chairman of the CHX Holdings Board will appoint the Executive, Audit, and Compensation Committees of CHX Holdings, subject to the approval of the CHX Holdings

¹⁴ See CHX Holdings Bylaws, Article II, Section 5.

¹⁵ See CHX Holdings Bylaws, Article II, Section 5.

¹⁶ See CHX Holdings Bylaws, Article II, Section 3.

¹⁷ See CHX Holdings Bylaws, Article IV, Section 11.

¹⁸ See CHX Holdings Bylaws, Article IV, Section 9.

¹⁹ See CHX Holdings Bylaws, Article V, Section 1.

²⁰ See CHX Holdings Bylaws, Article II, Section 3.

Board.²¹ The Vice Chairman of CHX Holdings will appoint the members of other standing and special committees, subject to the approval of the CHX Holdings Board.²² Each committee will have the authority and responsibilities determined by the CHX Holdings Board.²³

(c) Officers of CHX Holdings

The officers of CHX Holdings will be the CEO of CHX Holdings, one or more Vice Presidents, a Secretary, a Treasurer, and such other officers, including a President, as the CHX Holdings Board or the CEO of CHX Holdings determine.²⁴ The CHX Holdings Board will appoint the CEO of CHX Holdings, who will manage the business affairs of CHX Holdings.²⁵ The officers of CHX Holdings will have the responsibilities and authority set out in the CHX Holdings Bylaws or given to them by the CEO of CHX Holdings. As an initial matter, the CEO of CHX will act as the CEO of CHX Holdings and will appoint as officers of CHX Holdings such officers of CHX as he believes are necessary to carry out the business of CHX Holdings.

(d) Shareholder Restrictions

The Certificate of Incorporation of CHX Holdings places certain restrictions on the ability to transfer, own, and vote the stock of CHX Holdings.

(i) Restrictions on voting

²¹ See CHX Holdings Bylaws, Article V, Section 2.

²² See CHX Holdings Bylaws, Article II, Section 5, and CHX Holdings Bylaws, Article V, Section 2.

²³ See CHX Holdings Bylaws, Article V, Section 3.

²⁴ See CHX Holdings Bylaws, Article VI, Section 1.

²⁵ See CHX Holdings Bylaws, Article VI, Section 4.

The Certificate of Incorporation of CHX Holdings generally prohibits any Person, either alone or together with its Related Persons,²⁶ 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 CHX Holdings; or (b) entering into any agreement, plan, or arrangement that would result in the shares of CHX 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, possessing the right to vote or causing the vote of more than 20% of the voting power of the then-issued and outstanding capital stock of CHX Holdings.²⁷

The CHX Holdings Board may waive the voting limitation by approving an amendment to the CHX Holdings Bylaws. Before approving a waiver, the CHX Holdings Board must determine that, among other things, the waiver of the voting limitation will not impair the ability of CHX to carry out its functions and responsibilities under the Act and will not impair the Commission's ability to enforce the Act.²⁸ In addition, the CHX Holdings Board also must determine that a Person and any Related Persons that would vote more than 20% of the

²⁶ Article Fifth of the CHX 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." A "Related Person" means "(A) with respect to any Person, all 'affiliates' and 'associates' of such Person (as such terms are defined in Rule 12b-2 under the Securities Exchange Act of 1934, as amended); (B) with respect to any Person that holds a permit issued by the Chicago Stock Exchange, Inc. to trade securities on the Chicago Stock Exchange (a 'Participant'), any broker or dealer with which a Participant is associated; and (C) any two or more Persons that have any agreement, arrangement or understanding (whether or not in writing) to act together for the purpose of acquiring, voting, holding or disposing of shares of the capital stock of the Corporation." See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (a).

²⁷ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(ii)(C).

²⁸ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(iii)(B).

outstanding stock of CHX Holdings is not subject to an applicable "statutory disqualification" (within the meaning of Section 3(a)(39) of the Act).²⁹ Finally, any amendment to the CHX Holdings Bylaws that would permit a Person to vote more than 20% of the outstanding stock of CHX Holdings must be filed with and approved by the Commission.³⁰

(ii) Restrictions on ownership

The CHX Holdings Certificate of Incorporation generally prohibits any Person, alone or together with its Related Persons, from owning, of record or beneficially, shares constituting more than 40% of any class of capital stock of CHX Holdings.³¹ The CHX Holdings Board may waive the ownership limitation by approving an amendment to the CHX Holdings Bylaws. Before approving the ownership waiver, the CHX Holdings Board must determine that, among other things, the waiver of the ownership limitation would not impair the ability of CHX to carry out its functions and responsibilities under the Act and would not impair the Commission's ability to enforce the Act.³² In addition, the CHX Holdings Board also must determine that a Person and any Related Persons that would own more than 40% of the outstanding stock of CHX Holdings is not subject to an applicable "statutory disqualification" (within the meaning of Section 3(a)(39) of the Act).³³ Finally, any amendment to the CHX Holdings Bylaws that would

²⁹ 15 U.S.C. 78c(a)(39).

³⁰ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(iii)(B) and paragraph (b)(iv).

³¹ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(ii)(A). See also CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(iii)(A).

³² See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(iii)(C).

³³ 15 U.S.C. 78c(a)(39).

permit a Person to own more than 40% of the outstanding stock of CHX Holdings must be filed with and approved by the Commission.³⁴

The CHX Holdings Certificate of Incorporation places further restrictions on those shareholders of CHX Holdings that also hold CHX trading permits. Specifically, CHX Participants and their Related Persons may not own, of record or beneficially, shares constituting more than 20% of any capital stock of CHX Holdings.³⁵ The CHX Holdings Board may not waive this restriction.

(iii) Other shareholder requirements

The CHX Holdings has several provisions in its Certificate of Incorporation that will enable it to enforce the ownership and voting restrictions. Specifically, if a shareholder purports to sell, transfer, assign, or pledge any shares to any Person in a transaction that would violate the ownership restrictions described above, CHX Holdings will record on its books the transfer of only the number of shares that would not violate these restrictions and will treat the remaining shares as owned by the purported transferor for all purposes, including, without limitation, voting, payment of dividends, and distributions.³⁶ In addition, if any shareholder purports to vote, or to grant any proxy or enter into any agreement relating to the voting of shares that would violate the voting restrictions described above, CHX Holdings will not honor such vote, proxy, or agreement, and any shares subject to that arrangement will not be entitled to be voted to the extent of the violation.³⁷ Finally, if any shareholder purports to sell, transfer, assign, pledge, or vote any shares in a transaction that would violate the voting and ownership concentration limits,

³⁴ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(iii)(B) and paragraph (b)(iv).

³⁵ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(ii)(B).

³⁶ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (d).

³⁷ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (d).

CHX Holdings will have the right to redeem such shares at a price equal to the par value of the shares, upon the approval of the CHX Holdings Board.³⁸

A shareholder that alone or together with its Related Persons owns, of record or beneficially, five percent or more of the then outstanding shares of the capital stock of CHX Holdings, must immediately give the CHX Holdings Board written notice of such ownership.³⁹

Shareholders may dispose of shares of CHX Holdings only in minimum lots of 1,000 shares.⁴⁰

(e) Self-Regulatory Function and Oversight

The CHX Holdings Bylaws contain various provisions designed to protect the independence of the self-regulatory function of CHX and to clarify the Commission's oversight responsibilities. For example, pursuant to the CHX Holdings Bylaws, CHX Holdings must give due regard to the preservation of the independence of the self-regulatory function of CHX and to its obligations to investors and the general public. In addition, CHX Holdings is specifically prohibited from taking any actions that would interfere with the effectuation of any decisions by the Board of Directors of CHX ("CHX Board") relating to CHX's regulatory functions, including disciplinary matters or the structure of the market it regulates, or that would interfere with CHX's ability to carry out its responsibilities under the Act.⁴¹ The CHX Holdings Bylaws contain a specific requirement that all books and records of CHX, and the information contained therein, that reflect confidential information pertaining to the self-regulatory function of CHX, which comes into the possession of CHX Holdings must be retained in confidence by CHX Holdings

³⁸ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (e).

³⁹ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (c)(i).

⁴⁰ See CHX Holdings Bylaws, Article IX, Section 2.

⁴¹ See CHX Holdings Bylaws, Article III, Section 1.

and its Board, officers, employees, and agents, and must not be used for any non-regulatory purposes.⁴²

The CHX Holdings Bylaws also provide that, to the extent they are related to the activities of CHX, the books, records, premises, officers, directors, agents, and employees of CHX Holdings are deemed to be the books, records, premises, officers, directors, agents, and employees of CHX for the purposes of, and subject to oversight pursuant to, the Act.⁴³

With regard to the Commission's ability to oversee the activities of CHX, the CHX Holdings Bylaws provide that the officers, directors, employees, and agents of CHX Holdings, by virtue of their acceptance of such position, are deemed to agree to cooperate with the Commission and CHX in respect of the Commission's oversight responsibilities regarding CHX and the self-regulatory functions and responsibilities of CHX.⁴⁴ In addition, the CHX Holdings Bylaws provide that CHX Holdings and its officers, directors, employees, and agents, by virtue of their acceptance of such position, will be deemed to irrevocably submit to the jurisdiction of the U.S. federal courts, the Commission, and CHX, for the purpose 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 CHX.⁴⁵ Further, CHX Holdings and its officers,

⁴² See CHX Holdings Bylaws, Article III, Section 2.

⁴³ See CHX Holdings Bylaws, Article III, Section 3. The Commission notes that the staff of CHX has indicated that it will present to the CHX Holdings Board for its approval a proposed new CHX Holdings Bylaws provision confirming that CHX Holdings will take such action as is necessary to ensure that its officers, directors, and employees consent to the applicability of Article III, Section 3, and Article III, Section 5 of the CHX Holdings Bylaws with respect to CHX-related activities. See Amendment No. 3, supra note 4.

⁴⁴ See CHX Holdings Bylaws, Article III, Section 4.

⁴⁵ See CHX Holdings Bylaws, Article III, Section 5. The Commission notes that the staff of CHX has indicated that it will present to the CHX Holdings Board for its approval a proposed new CHX Holdings Bylaws provision stating that CHX Holdings will take such action as is necessary to ensure that its officers, directors, and employees consent to the

directors, employees, and agents, by virtue of their acceptance of 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 CHX; that the suit, action, or proceeding is in an inconvenient forum; that the venue of the suit, action, or proceeding is improper; or that the subject matter thereof may not be enforced in or by such courts or agency.⁴⁶

Finally, the CHX Holdings Certificate of Incorporation and the CHX Holdings Bylaws provide that, before any amendment or repeal of a provision in the Certificate of Incorporation or the Bylaws, respectively, will be effective, it must be submitted to the CHX Board and if the CHX Board determines that the amendment or repeal of the provision must be filed with the Commission before it may be effective, the amendment or repeal of the provision will not be effective until it is filed with, or filed with and approved by the Commission, as the case may be.⁴⁷

2. CHX

Following the demutualization, CHX will become a Delaware for-profit stock corporation that will be wholly-owned by CHX Holdings. CHX, however, will continue to be the entity registered as a national securities exchange under Section 6 of the Act⁴⁸ and, accordingly, CHX will continue to be a self-regulatory organization (“SRO”).

(a) Governing Documents and CHX Rules

applicability of Article III, Section 3, and Article III, Section 5 of the CHX Holdings Bylaws with respect to CHX-related activities. See Amendment No. 3, supra note 4.

⁴⁶ See CHX Holdings Bylaws, Article III, Section 5.

⁴⁷ See CHX Holdings Certificate of Incorporation, Article Thirteenth, and CHX Bylaws, Article VIII.

⁴⁸ 15 U.S.C. 78f.

The CHX Certificate of Incorporation, CHX Bylaws, and CHX rules will govern the activities of CHX. CHX's rules and Bylaws are proposed to reflect, among other things, CHX's status as wholly-owned subsidiary of CHX Holdings, its management by the CHX Board and its designated officers, and its self-regulatory responsibilities pursuant to CHX's registration under Section 6 of the Act.

(b) Board of Directors

The CHX Board will consist of between 10 and 16 persons, as determined by the CHX Board, including the CEO of CHX.⁴⁹ Initially, the CHX Board will have 14 directors, whom the Chairman, Vice Chairman, and CEO of CHX will select from among the persons currently serving on the Exchange's Board of Governors. The directors will be divided into three classes, which will be as nearly equal in number as the total number of directors then constituting the entire CHX Board permits, and will serve staggered three-year terms with the term of office of one class expiring each year.⁵⁰

The CHX Board will be comprised of the CEO of CHX, persons who qualify as "Participant Directors," and persons who qualify as "Public Directors."⁵¹ One-half of the

⁴⁹ See CHX Certificate of Incorporation, Article Fifth, paragraph (b), and CHX Bylaws, Article II, Section 2(a). CHX's current Board of Governors consists of 24 governors.

⁵⁰ See CHX Certificate of Incorporation, Article Fifth, paragraph (d), and CHX Bylaws, Article II, Section 2(c).

⁵¹ See CHX Certificate of Incorporation, Article Fifth, paragraph (c), and CHX Bylaws, Article II, Section 2(b). CHX's Bylaws define a "Public Director" as a director who (i) is not a participant or an officer, managing member, partner or employee of an entity that is a participant, (ii) is not an employee of CHX, CHX Holdings or any of their affiliates, (iii) is not a broker or dealer or an officer or employee of a broker or dealer, or (iv) does not have any other material business relationship with CHX, CHX Holdings, or any of their affiliates or any broker or dealer. See CHX Bylaws, Article II, Section 2(b). A "Participant Director" is a director who is a CHX participant or an officer, managing member, or partner of an entity that is a CHX participant. A "participant" is any individual, corporation, partnership, or other entity that holds a permit issued by CHX to trade securities on CHX. See CHX Bylaws, Article II, Section 2(b). See also CHX

number of CHX directors comprising the entire CHX Board must be Public Directors, and the remaining directors, other than the CEO of CHX, will be Participant Directors.⁵² The CHX Board's initial directors will include the CEO of CHX, seven Public Directors, and six Participant Directors.

The CHX Board will elect its Chairman from among the CEO of CHX and the Public Directors.⁵³ The Chairman of the CHX Board may serve as the CEO of CHX but may hold no other office in CHX.⁵⁴ The Participant Directors will elect the Vice Chairman of the CHX Board, who may not hold any other office in CHX, from among the Participant Directors.⁵⁵

(c) Nomination and Election of Directors

After the formation of the initial CHX Board, the CHX Nominating and Governance Committee, which will be comprised of three Public Directors and three Participant Directors appointed by the CHX Board, will nominate directors for each director position standing for election at the annual meeting of shareholders that year.⁵⁶ Because CHX Participants will not be shareholders of CHX, they are not entitled to directly elect members of the CHX Board. CHX Holdings, as the sole shareholder of CHX, will have the sole right and the obligation to vote for the directors of the CHX Board. However, to ensure that CHX Participants are afforded fair

Rules, Article I, Rule1(l). The definition of "Public Director" will replace the definitions of "non-industry governor" and "public governor" set out in the Exchange's current governing documents.

⁵² See CHX Certificate of Incorporation, Article Fifth, paragraph (c), and CHX Bylaws, Article II, Section 2(b).

⁵³ See CHX Bylaws, Article II, Section 4(a).

⁵⁴ See CHX Bylaws, Article II, Section 4(a).

⁵⁵ See CHX Bylaws, Article II, Section 5(a).

⁵⁶ See CHX Bylaws, Article II, Section 3. In addition, the CHX Nominating and Governance Committee will periodically review the organization and governance structure of CHX. See CHX Rules, Article IV, Rule 11.

representation as required under Section 6(b)(3) of the Act, CHX has proposed a procedure whereby CHX Participants will be involved in the selection of Participant Director nominees.⁵⁷

Specifically, the CHX Nominating and Governance Committee will hold two open meetings with CHX participants for the purpose of receiving recommendations of candidates for election to the Participant Director positions. The CHX Nominating and Governance Committee's initial candidates for nomination will be announced to CHX participants, who will then have the opportunity to identify additional candidates for nomination by submitting a petition signed by at least ten participants. If no petitions are submitted within the time frame prescribed by the CHX Bylaws, the CHX Nominating and Governance Committee will nominate the candidates it initially identified. If one or more valid petitions are submitted, the participants will vote on the entire group of potential candidates, and the individuals receiving the largest number of votes will be the persons approved by the participants as Participant Director nominees. Each participant will have one vote per trading permit with respect to each Participant Director position that is to be filled.⁵⁸

(d) Committees

The CHX Board will have the following standing committees: (1) an Executive Committee; (2) a Nominating and Governance Committee; (3) an Audit Committee; (4) a

⁵⁷ After the Commission approves the proposal, CHX Holdings will enter into a voting agreement with CHX confirming its obligation to vote for the directors nominated through the process set out in the CHX Bylaws.

⁵⁸ No participant or participant firm is allowed to hold more trading permits than are necessary to the conduct of business on the Exchange. All trading permits must be held by an active participant or must be held by an active participant firm, where the participant firm has assigned an active participant as its nominee. See CHX Rules, Article II, Rule 2(e).

Compensation Committee; (5) a Regulatory Oversight Committee ("ROC"); (6) a Finance Committee; and (7) a Judiciary Committee.⁵⁹

As noted above, the CHX Nominating and Governance Committee will be appointed by the CHX Board. The Chairman and Vice Chairman of the CHX Board will appoint CHX's Executive, Audit, Finance, and Compensation Committees, subject to the approval of the CHX Board. CHX's Executive, Compensation, and Audit Committees will have a majority of Public Directors.⁶⁰ The Executive Committee will have the powers that the CHX Board delegates to it and, between meetings of the CHX Board, will have the rights, powers, authority, duties, and obligations of the CHX Board not otherwise delegated to another committee, except the authority to propose amendments to the CHX Certificate of Incorporation, adopt an agreement of merger or consolidation, recommend to shareholders the sale, lease or exchange of all or substantially all or of the property and assets of CHX, or recommend to the shareholders a dissolution of CHX or the revocation of a dissolution.⁶¹

The revised description of the role of the CHX Audit Committee indicates that, among other things, the Audit Committee has "direct responsibility and authority to engage and oversee

⁵⁹ See CHX Bylaws, Article IV, Section 1. Information about the composition and responsibilities of the Exchange's committees appears in Article IV of the Exchange's rules.

⁶⁰ See CHX Rules, Article IV, Rules 2, 8, and 9. The proposal revises CHX's current rules governing its Audit and Compensation Committees by providing that a majority, not just 50%, of the members of the Audit and Compensation Committees must be Public Directors.

⁶¹ See CHX Rules, Article IV, Rule 2. The proposal also deletes the requirements that members of the Executive Committee be chosen (a) with a view to providing representation to the various geographical areas in which there are member organizations that support the Exchange; and (b) with a view to having persons on the committee who are interested in and knowledgeable about the Exchange's business operations and the securities industry as a whole.

the work of the independent public accountant retained to audit the Exchange's financial statements...."⁶²

The Vice Chairman of the CHX Board will appoint CHX's ROC, subject to the approval of the Public Directors of the CHX Board. Five of the seven members of the ROC will be Public Directors.⁶³ In its filing, CHX represented that it believed that the composition, responsibilities, and appointment mechanism associated with the ROC were consistent with the requirements set out in the Commission's September 30, 2003, settlement order with CHX.⁶⁴

The CEO of CHX will continue to appoint CHX's Judiciary Committee.⁶⁵ The Vice Chairman of the CHX Board will appoint other committees, including the newly-formed Participant Advisory Committee of CHX, subject to the approval of the CHX Board.⁶⁶ The CHX Participant Advisory Committee, which will be comprised entirely of CHX participants, will recommend rules for adoption by the CHX Board and advise the CHX management regarding enhancements to the Exchange's trading facilities and other matters that affect participants.⁶⁷ According to CHX, the Participant Advisory Committee is designed to provide participants with a formal opportunity to share their concerns and ideas with the CHX management.

⁶² See CHX Rules, Article IV, Rule 9.

⁶³ See CHX Rules, Article IV, Rule 4.

⁶⁴ See In the Matter of the Chicago Stock Exchange, Securities Exchange Act Release No. 48566 (September 30, 2003) (Admin. Proc. File No. 3-11282) (Order Instituting Public Administrative Proceedings Pursuant to Sections 19(h) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Censure, a Cease-and-Desist Order and Other Relief) ("CHX Settlement Order").

⁶⁵ See CHX Rules, Article IV, Rule 7.

⁶⁶ See CHX Bylaws, Article IV, Section 2.

⁶⁷ See CHX Rules, Article IV, Rule 10.

Each committee will have the authority and responsibilities prescribed for it in the CHX Bylaws or rules or by the CHX Board.⁶⁸

(e) Management

The officers of CHX will be the CEO, one or more Vice Presidents, a Secretary, and a Treasurer, and such other officers, including a President, as the CHX Board or the CEO may determine.⁶⁹ The CEO of CHX will be responsible to the CHX Board for the management of its business affairs.⁷⁰

(f) Self-Regulatory Function and Oversight

As noted above, following the demutualization CHX will continue to be registered as a national securities exchange under Section 6 of the Act and thus will continue to be an SRO.⁷¹ As an SRO, CHX will be obligated to carry out its statutory responsibilities, including enforcing compliance by CHX participants and participant firms with the provisions of the federal securities laws and the applicable rules of CHX. Further, CHX will retain the responsibility to administer and enforce the rules that govern CHX's and its members' activities. In addition, CHX will continue to be required to file with the Commission, pursuant to Section 19(b) of the Act⁷² and Rule 19b-4 thereunder,⁷³ any changes to its rules and governing documents.

Like the Bylaws of CHX Holdings, the Bylaws of CHX contain specific provisions relating to the self-regulatory function of CHX.⁷⁴ For example, the CHX Bylaws require the

⁶⁸ See CHX Bylaws, Article IV, Section 3.

⁶⁹ See CHX Bylaws, Article V, Section 1.

⁷⁰ See CHX Bylaws, Article V, Section 4.

⁷¹ See 15 U.S.C. 78c(a)(26).

⁷² 15 U.S.C. 78s(b).

⁷³ 17 CFR 240.19b-4.

⁷⁴ See CHX Bylaws, Article X, Section 1.

CHX Board to consider applicable requirements under Section 6(b) of the Act in connection with the management of the Exchange.⁷⁵ In addition, meetings of the CHX Board and of its committees that pertain to the self-regulatory function of CHX or to the structure of the market CHX regulates must be closed to persons who are not members of the CHX Board or CHX officers, staff, counsel, or other specifically identified persons.⁷⁶ Further, the CHX books and records reflecting confidential information relating to the self-regulatory function of CHX must be kept confidential and must not be used for non-regulatory purposes, and the books and records of CHX must be maintained in the U.S.⁷⁷

The CHX Bylaws also provide that any revenues received by CHX from regulatory fees or penalties must be applied to fund the legal and regulatory operations of CHX and may not be used to pay dividends.⁷⁸

(g) Restrictions on ownership

Although there are no percentage-based restrictions on the ownership of CHX, the CHX Certificate of Incorporation confirms that CHX Holdings is the sole shareholder of CHX.⁷⁹ Any

⁷⁵ See CHX Bylaws, Article X, Section 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 thereunder, and the rules of the Exchange.

⁷⁶ See CHX Bylaws, Article X, Section 2.

⁷⁷ See CHX Bylaws, Article X, Sections 3 and 4.

⁷⁸ See CHX Bylaws, Article X, Section 5. Regulatory penalties that are intended to benefit customers, by, for example, providing restitution, must be provided to those customers and CHX will not be use them for any purpose.

⁷⁹ See CHX Certificate of Incorporation, Article Fourth.

changes to this provision of the CHX Certificate of Incorporation cannot take effect until they are filed with and approved by the Commission pursuant to Section 19(b) of the Act.⁸⁰

(h) National Market System Plans

CHX currently is a participant in various national market system ("NMS") plans, including the Consolidated Tape Association Plan, the Consolidated Quotation System Plan, the Intermarket Trading System Plan, and the Reporting Plan for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis ("Nasdaq UTP") Plan.⁸¹ 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, CHX, in its continuing role as the SRO, will continue to serve as the voting member of these NMS plans, and a representative of CHX will continue to serve as CHX's representative with respect to dealing with these plans.⁸²

B. Trading Permits

Following CHX's demutualization, persons and firms who have been qualified for membership under Articles 1, 2, or 3 of the Exchange's current rules and, as a result, have access to the Exchange's trading floor and other facilities will receive trading permits entitling them to maintain their trading access to CHX. Each trading permit will constitute a revocable license allowing the holder of the permit to access CHX trading facilities in the same manner as previously authorized for CHX's qualified trading members.⁸³ According to CHX, the

⁸⁰ 15 U.S.C. 78s(b).

⁸¹ See Amendment No. 3, supra note 4.

⁸² See Amendment No. 3, supra note 4.

⁸³ See CHX Rules, Article II, Rule 2.

demutualization and the implementation of the use of trading permits will not change current CHX member access to the Exchange or their ability to execute transactions.

Persons holding trading permits of CHX will be “members” of CHX for purposes of the Act and will be characterized as “participants” in CHX subject to CHX’s regulatory jurisdiction.⁸⁴ Trading permit holders will not have any ownership interest in CHX or in CHX Holdings by virtue of their trading permits.

Following the demutualization, CHX will require persons seeking trading permits to complete appropriate application materials and registration forms, satisfy regulatory requirements, and pay processing charges and application fees. This process will be substantially similar to the current membership application process.⁸⁵ An individual participant may obtain only one trading permit, and a participant firm may obtain multiple trading permits and may assign a nominee to each trading permit. Each person transacting business on the Exchange will require a trading permit. For example, a CHX specialist firm with 50 co-specialists would need to obtain 50 trading permits and register each co-specialist as a nominee. No participant or participant firm will be allowed to hold more trading permits than are necessary to conduct business on the Exchange, and all trading permits must be held by an active participant or an active participant firm, where the participant firm has assigned an active participant as its nominee.⁸⁶

Once issued, a CHX trading permit will be effective for one year following its issuance date and will renew automatically for an additional one-year term on each anniversary of the issuance date, unless the trading permit holder provides the Exchange with 60 days' prior written

⁸⁴ See CHX Rules, Article I, Rule 1(l) (definition of “Participant”).

⁸⁵ See CHX Rules, Articles II and III.

⁸⁶ See CHX Rules, Article II, Rule 2(e).

notice of the trading permit holder's waiver of renewal. If the participant waives the right to renew the permit, it will expire at the end of the then-current term.⁸⁷ A trading permit generally may not be sold, leased, or otherwise transferred, although a participant firm may transfer its trading permit from the name of one nominee employee to the name of another nominee employee, with the approval of CHX.⁸⁸ CHX will have the ability to suspend or revoke a trading permit for the same reasons that it is currently entitled to suspend or revoke a membership and/or sell a seat.⁸⁹

Currently, CHX rules permit a person (referred to as an “approved lessor”) to purchase a membership solely for the purpose of providing a financing mechanism for another person seeking access to CHX.⁹⁰ Following demutualization, no person will be permitted to operate as an approved lessor or otherwise lease trading access to the Exchange.

There will be nominal processing charges and application fees relating to the issuance of trading permits. In addition, all participants and participant firms will be subject to an annual trading permit fee of \$6,000 per year, payable monthly, for each trading permit. This fee is identical to CHX's current fee for membership dues. These fees appear in the schedule of Participant Fees and Credits.

C. Other Provisions in the Certificate of Incorporation and Bylaws

1. Shareholder Ownership

The Bylaws for CHX Holdings and CHX contain provisions relating to issues associated with shareholder ownership, including provisions relating to the timing and conduct of meetings,

⁸⁷ See CHX Rules, Article II, Rules 3(d) and 7.

⁸⁸ See CHX Rules, Article II, Rule 6.

⁸⁹ See generally, CHX Rules, Articles VII and XII.

⁹⁰ See CHX Rules, Article IA.

record dates, quorum requirements, proxies, and other matters.⁹¹ According to CHX, these provisions were designed to reflect current corporate practices and are identical for CHX Holdings and CHX.

2. Updated provisions of the CHX Certificate of Incorporation and Bylaws

The Exchange proposes to make several changes to CHX's Bylaws and Certificate of Incorporation to modernize CHX's governing documents. Among other things, these changes streamline the description of CHX's corporate purpose; confirm that the CHX Board has the authority to set the CHX Board's compensation; set out specific provisions relating to the authority of Exchange officers to enter into contracts, sign checks, and handle the funds of the Exchange; and provide that the Exchange will advance expenses, in appropriate circumstances, to directors, officers, and committee members of CHX who are named as defendants in certain actions relating to Exchange business.⁹²

D. Description of Amendment No. 3

In Amendment No. 3, CHX proposes to revise the proposal to: (1) confirm CHX's continuing participation in various NMS plans following the demutualization; (2) correct a typographical error in the numbering of the articles of the CHX Bylaws; (3) indicate that the staff of CHX will present to the CHX Holdings Board for its approval a proposed new CHX Holdings Bylaws provision stating that CHX Holdings will take such action as is necessary to insure that its officers, directors, and employees consent to the applicability of Article III, Section 3, and

⁹¹ See CHX Holdings Bylaws, Article IV, and CHX Bylaws, Article III.

⁹² See CHX Certificate of Incorporation, Article Third (corporate purpose); CHX Bylaws Article II, Section 15 (CHX Board compensation), Article IX (contracts, loans, checks, and deposits), and Article VI (indemnification and advancing of expenses).

Article III, Section 5 of the CHX Holdings Bylaws with respect to CHX-related activities;⁹³ and (4) revise language regarding the admission of new participants.

III. 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.⁹⁴ In particular, the Commission finds that the proposed rule change, as amended, is consistent with Section 6(b)(1) of the Act,⁹⁵ 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,⁹⁶ which requires that the rules of a national securities exchange assure the fair representation of its members in the selection of its directors and

⁹³ Article III, Section 3 of the CHX Holdings Bylaws provides that, to the extent they are related to the activities of CHX, the books, records, premises, officers, directors, agents, and employees of CHX Holdings will be deemed to be the books, records, premises, officers, directors, agents, and employees of CHX for the purposes of, and subject to oversight pursuant to, the Act. In addition, Article III, Section 5 of the CHX Holdings Bylaws provides that CHX Holdings and its officers, directors, employees, and agents, by virtue of their acceptance of such position, shall be deemed irrevocably to submit to the jurisdiction of the U.S. federal courts, the Commission, and CHX, 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 CHX. Article III, Section 5, also states that CHX Holdings and its officers, directors, employees, and agents, by virtue of their acceptance of 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 CHX; that the suit, action, or proceeding is in an inconvenient forum; that the venue of the suit, action, or proceeding is improper; or that the subject matter thereof may not be enforced in or by such courts or agency.

⁹⁴ 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).

⁹⁵ 15 U.S.C. 78f(b)(1).

⁹⁶ 15 U.S.C. 78f(b)(3).

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,⁹⁷ 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. CHX Holdings as Sole Shareholder

Following completion of the demutualization, CHX Holdings will be the sole shareholder of CHX. Section 19(b) of the Act⁹⁸ and Rule 19b-4 thereunder⁹⁹ require an SRO to file proposed rule changes with the Commission. Although CHX Holdings is not an SRO, certain provisions of its Certificate of Incorporation and Bylaws may be rules of an exchange¹⁰⁰ if they are the stated policies, practices, or interpretations, as defined in Rule 19b-4 of the Act, of CHX. 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, CHX has filed the CHX Holdings Certificate of Incorporation and CHX Holdings Bylaws with the Commission. If CHX Holdings decides to change its Certificate of Incorporation or Bylaws, it must submit such changes to the CHX Board so that it can

⁹⁷ 15 U.S.C. 78f(b)(5).

⁹⁸ 15 U.S.C. 78s(b).

⁹⁹ 17 CFR 240.19b-4.

¹⁰⁰ Section 3(a)(27) of the Act defines the rules of an exchange to be the constitution, articles of incorporation, bylaws, 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).

determine if the changes must be filed with, and approved by, the Commission. The Commission believes that these provisions will assist CHX in fulfilling its self-regulatory obligations and in administrating and complying with the requirements under the Act.

B. Changes in Control of CHX

The Commission believes that the restrictions in the CHX Holdings Certificate of Incorporation on direct and indirect changes in control of CHX Holdings are sufficient to enable CHX to carry out its self-regulatory responsibilities and to enable the Commission to fulfill its responsibilities under the Act.¹⁰¹

Specifically, as proposed, CHX will be wholly-owned subsidiary of CHX Holdings, *i.e.*, CHX Holdings will own all of the shares of CHX. The CHX Certificate of Incorporation identifies this ownership structure.¹⁰² Any changes to the CHX Certificate of Incorporation, including any change to the provision that identifies CHX shareholders, must be filed with, and approved by, the Commission pursuant to Section 19(b) of the Act.¹⁰³

In addition, the CHX Holdings Certificate of Incorporation imposes limitations on direct and indirect changes in control of CHX Holdings through voting and ownership limitations placed on the capital stock of CHX Holdings (whether common or preferred stock) and allows CHX Holdings to monitor potential changes in control through a notification requirement once a

¹⁰¹ The Commission notes that it is in the process of reviewing issues related to new ownership structures of SROs and has proposed rules relating to the ownership of SROs, including limiting the restrictions on ownership and voting to members of an SRO or a facility of an SRO. See Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004) ("Proposed Rulemaking"). See also Securities Exchange Act Release No. 51019 (January 11, 2005), 70 FR 2829 (January 18, 2005) (extending the comment period for the Proposed Rulemaking until March 8, 2005).

¹⁰² See CHX Certificate of Incorporation, Article Fourth.

¹⁰³ 15 U.S.C. 78s(b).

threshold percentage of ownership of capital stock is reached.¹⁰⁴ Specifically, the CHX 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 shares of CHX Holdings.¹⁰⁵ Furthermore, the CHX 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.¹⁰⁶ The CHX 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 the outstanding shares of capital stock of CHX Holdings.¹⁰⁷

If any shareholder votes, sells, transfers, assigns, or pledges any shares in violation of the voting and ownership limitations, CHX Holdings will treat those shares as owned by the transferor for all purposes, including, without limitation, voting, payment of dividends, and distributions.¹⁰⁸ In addition, if any shareholder votes, sells, transfers, assigns, or pledges any

¹⁰⁴ The CHX Holdings Certificate of Incorporation requires that any person, either alone or together with its affiliates or associates or any other person, who at any time owns five percent or more of then outstanding shares of capital stock and who has the right to vote in the election of the CHX Holdings Board, shall, immediately upon so owning five percent or more of the then outstanding shares of such stock, give the CHX Holdings Board a written notice of such ownership and update that notice promptly after an ownership change of a specified percentage. See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (c).

¹⁰⁵ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(ii)(C). See note 26, supra, for the definitions of "Person" and "Related Person."

¹⁰⁶ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(ii)(C).

¹⁰⁷ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(ii)(A).

¹⁰⁸ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (d).

shares in violation of the voting and ownership limitations, CHX Holdings has the right to redeem those shares at a price equal to the par value thereof, upon the approval of the CHX Holdings Board.¹⁰⁹

The CHX Holdings Board has the authority to waive these voting and ownership limitations by adopting an amendment to the CHX Holdings Bylaws. The CHX Holdings Board must determine that the waiver of a voting or ownership requirement will not impair CHX's ability to carry out its self-regulatory functions and will not impair the Commission's ability to enforce the Act. In addition, the CHX Holdings Board must determine that the person to whom it is giving either a voting or ownership waiver is not subject to any applicable "statutory disqualification" (within the meaning of Section 3(a)(39) of the Act¹¹⁰). Finally, the CHX Holdings Board must submit any amendment to the CHX Holdings Bylaws to the CHX Board, and if the CHX Board determines that the proposed change to the CHX Holdings Bylaws must be filed with the Commission, then the CHX Holdings Bylaw change will not be effective until it is filed with, or filed with and approved by the Commission, as the case may be.¹¹¹ The Commission believes that any such amendment to the CHX Holdings Bylaws would be a proposed rule change that would need to be filed with the Commission pursuant to Section 19(b) of the Act.¹¹² The proposed rule change would present the Commission with an opportunity to determine what additional measures, if any, might be necessary to provide sufficient regulatory jurisdiction over the proposed controlling person.

¹⁰⁹ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (e).

¹¹⁰ 15 U.S.C. 78c(a)(39).

¹¹¹ See CHX Holdings Bylaws, Article VIII. A similar requirement applies to changes to the CHX Holdings Certificate of Incorporation. See CHX Holdings Certificate of Incorporation, Article Thirteenth.

¹¹² 15 U.S.C. 78s(b).

CHX has also proposed to require CHX Holdings shareholders that own, of record or beneficially, five percent or more of the then outstanding shares to give the CHX Holdings Board written notice of such ownership. This notice should enable CHX Holdings to monitor the ownership of its stock to ensure that no limitation is reached.¹¹³

The CHX Holdings Certificate of Incorporation also provides that no Person, either alone or together with its Related Persons, who is a trading permit holder of CHX may own, directly or indirectly, shares constituting more than 20% of any class of capital stock of CHX Holdings.¹¹⁴

The Commission finds that the limitation on ownership of shares of CHX Holdings by CHX trading permit 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 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

¹¹³ The Commission believes that CHX 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 CHX 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 CHX Holdings Certificate of Incorporation.

¹¹⁴ See CHX Holdings Certificate of Incorporation, Article Fifth, paragraph (b)(ii)(B). Unlike the 40% ownership and 20% voting limitations discussed above, the CHX Holdings Board may not waive the 20% ownership limitation applicable to CHX trading permit holders.

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.¹¹⁵

C. Regulatory Jurisdiction over CHX Holdings

The Commission believes that the terms of CHX Holdings Bylaws provide the Commission with sufficient regulatory jurisdiction over the controlling parties of the Exchange to carry out its oversight responsibilities under the Act. The CHX Holdings Bylaws provide that, to the extent that they are related to the activities of CHX, the books, records, premises, officers, directors, agents, and employees of CHX Holdings are deemed to be the books, records, premises, officers, directors, agents, and employees of CHX for purposes of and subject to oversight pursuant to the Act.¹¹⁶ This provision would enable the Commission to exercise its authority under Section 19(h)(4) of the Act¹¹⁷ with respect to officers and directors of CHX Holdings, because all such officers and directors, to the extent that they are acting on matters

¹¹⁵ 15 U.S.C. 78f(b).

¹¹⁶ See CHX Holdings Bylaws, Article III, Section 3. As noted above, the staff of CHX has indicated that it will present to the CHX Holdings Board for its approval a proposed new CHX Holdings Bylaws provision stating that CHX Holdings will take such action as is necessary to ensure that its officers, directors, and employees consent to the applicability of Article III, Section 3, and Article III, Section 5 of the CHX Holdings Bylaws with respect to CHX-related activities. See Amendment No. 3, supra note 4.

¹¹⁷ 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.

related to CHX activities, would be deemed to be officers and directors of CHX. Furthermore, the books and records of CHX Holdings, to the extent that they are related to the activities of CHX, are subject to the Commission's examination authority under Section 17(b)(1) of the Act,¹¹⁸ as these records would be deemed to be the records of CHX itself.

In addition, pursuant to the CHX Holdings Bylaws, CHX 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 CHX 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.¹¹⁹ Moreover, CHX 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 CHX, 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.¹²⁰ Finally, the CHX Holdings Bylaws provide that the officers, directors, employees, and agents of CHX Holdings, by virtue of their acceptance of such position, are deemed to agree to cooperate with the Commission and CHX in respect of the

¹¹⁸ 15 U.S.C. 78q(b)(1).

¹¹⁹ See CHX Holdings Bylaws, Article III, Section 5. As noted above, the staff of CHX has indicated that it will present to the CHX Holdings Board for its approval a proposed new CHX Holdings Bylaws provision stating that CHX Holdings will take such action as is necessary to ensure that its officers, directors, and employees consent to the applicability of Article III, Section 3, and Article III, Section 5 of the CHX Holdings Bylaws with respect to CHX-related activities. See Amendment No. 3, supra note 4.

¹²⁰ See CHX Holdings Bylaws, Article III, Section 5.

Commission’s oversight responsibilities regarding CHX and the self-regulatory functions and responsibilities of CHX.¹²¹

The Commission also notes that, even in the absence of these provisions of the CHX Holdings Bylaws, Section 20(a) of the Act¹²² provides that any person with a controlling interest in CHX would be jointly and severally liable with and to the same extent that CHX 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 Act¹²³ 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 Act¹²⁴ 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 CHX. Moreover, CHX 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.¹²⁵ A failure on the part of CHX to enforce its rules could result in suspension or revocation of CHX's registration under Section 19(h)(1) of the Act.¹²⁶

D. Self-Regulatory Function of CHX

¹²¹ See CHX Holdings Bylaws, Article III, Section 4.

¹²² 15 U.S.C. 78t(a).

¹²³ 15 U.S.C. 78t(e).

¹²⁴ 15 U.S.C. 78u-3.

¹²⁵ 15 U.S.C. 78c(a)(27).

¹²⁶ 15 U.S.C. 78s(h)(1).

Following the demutualization, the rules and bylaws of CHX will reflect its status as a wholly-owned subsidiary of CHX Holdings, under management of the CHX Board and its designated officers and with self-regulatory obligations pursuant to CHX's registration as a national securities exchange under Section 6 of the Act.

As the sole shareholder of CHX, the Commission believes that CHX Holdings' activities with respect to its ownership of CHX must be consistent with CHX's obligations under the Act. Under the CHX Holdings Bylaws, the CHX Holdings Board and the officers, employees, and agents of CHX Holdings must give due regard to the preservation of the independence of the self-regulatory function of CHX 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 CHX Board relating to its regulatory functions or the structure of the market it regulates or which would interfere with the ability of CHX to carry out its responsibilities under the Act.¹²⁷ In addition, all books and records of CHX reflecting confidential information pertaining to its self-regulatory function (including but not limited to disciplinary matters, trading data, trading practices, and audit information) which come into the possession of CHX Holdings, and the information contained therein, must be retained in confidence by CHX Holdings and its directors, officers, employees, and agents and must not be used for any non-regulatory purposes.¹²⁸ The Commission believes that these provisions, which are designed to acknowledge the need to maintain the independence of the self-regulatory role of CHX following the demutualization and protect from improper use information pertaining to its self-regulatory function, are appropriate.

Further, the Commission notes that the CHX Bylaws expressly require that the CHX Board consider applicable requirements for registration as a national securities exchange under

¹²⁷ See CHX Holdings Bylaws, Article III, Section 1.

¹²⁸ See CHX Holdings Bylaws, Article III, Section 2.

Section 6(b) of the Act,¹²⁹ 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.¹³⁰ In the Commission's view, this provision should serve to remind the CHX 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 Act¹³¹ 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 Act¹³² requires that an exchange be so organized and have the capacity to be able to carry out the purposes of the Act.

CHX has proposed to amend the size and composition of its Board. Specifically, the CHX Board will have no less than ten and no more than 16 directors. At least 50% of the total number of directors on the CHX Board must be Public Directors and the remaining directors will be Participant Directors and the CEO.

¹²⁹ 15 U.S.C. 78f(b).

¹³⁰ See CHX Bylaws, Article X, Section 1.

¹³¹ 15 U.S.C. 78f(b)(3).

¹³² 15 U.S.C. 78f(b)(1).

Because CHX's participants will not be shareholders of CHX, they will not directly elect members of the CHX Board. As the sole shareholder of CHX, CHX Holdings will have the sole right and obligation to vote for the director nominees nominated by the CHX Nominating and Governance Committee.¹³³ The CHX Bylaws, however, establish a procedure that will allow participants to be involved in the selection of candidates to fill Participant Director positions on the CHX Board.¹³⁴ Each participant will have one vote per trading permit with respect to each Participant Director position to be filled.¹³⁵

Under the procedures for selecting Participant Director candidates,¹³⁶ the CHX Nominating and Governance Committee, which will have three Participant Directors and three Public Directors, will hold two open meetings with CHX participants for the purpose of receiving recommendations of candidates for election to the position of Participant Director. The CHX Nominating and Governance Committee's initial candidates for nomination will be announced to CHX participants, who will then have the opportunity to identify additional candidates for nomination by submitting a petition signed by at least ten participants. If no petitions are submitted within the time frame prescribed by the CHX Bylaws, the CHX Nominating and Governance Committee will nominate the candidates it initially identified. If one or more valid petitions are submitted, the participants will vote on the entire group of

¹³³ Upon approval of the demutualization, CHX Holdings will enter into a voting agreement with CHX confirming its obligation to vote for the directors nominated through the process set out in the CHX Bylaws.

¹³⁴ See CHX Bylaws, Article II, Section 3.

¹³⁵ As noted above, no participant or participant firm is allowed to hold more trading permits than are necessary to the conduct of business on the Exchange. All trading permits must be held by an active participant or must be held by an active participant firm, where the participant firm has assigned an active participant as its nominee. See CHX Rules, Article II, Rule 2(e).

¹³⁶ See CHX Bylaws, Article II, Section 3.

potential candidates, and the individuals receiving the largest number of votes will be the persons approved by the participants as Participant Director nominees. The CHX Nominating and Governance Committee will nominate only those persons whose names have been presented to, and approved by, CHX's participants pursuant to the procedures set forth in the CHX Bylaws.¹³⁷ CHX Holdings, as the sole shareholder of CHX, will have the sole right and obligation to vote for the director nominees nominated by the CHX Nominating and Governance Committee.¹³⁸

In addition to their representation on the CHX Nominating and Governance Committee, CHX participants will participate on other committees of CHX. For example, three of the seven members of the Committee on Exchange Procedure will be CHX participants, the Judiciary Committee will be comprised of five participants and/or general partners or officers of participant firms, and the ROC will include one on-floor Participant Director and one off-floor Participant Director. In addition, the newly-formed Participant Advisory Committee will have not less than five members, all of whom will be participants.¹³⁹ Among other things, the Participant Advisory Committee will recommend rules for adoption by the CHX Board and advise the CHX management regarding enhancements to the Exchange's trading facilities and other matters that affect participants. According to CHX, the Participant Advisory Committee is designed to provide participants with a formal opportunity to share their concerns and ideas with the CHX management.

Certain committees of the CHX Board will be comprised of a majority of Public Directors. Specifically, the Executive Committee, the Compensation Committee, and the Audit

¹³⁷ See CHX Bylaws, Article II, Section 3(b).

¹³⁸ See note 134, *supra*.

¹³⁹ See CHX Rules, Article IV, Rule 10.

Committee will be comprised of a majority of Public Directors.¹⁴⁰ The CHX Nominating and Governance Committee will consist of three Public Directors and three Participant Directors.¹⁴¹ Five of the seven members of the ROC will be Public Directors, and the Vice Chairman of the CHX Board will appoint the members of the ROC, subject to the approval of the Public Directors of the CHX Board.¹⁴² As noted above, CHX represents that the composition, responsibilities, and appointment mechanism associated with the ROC are consistent with the requirements set out in the CHX Settlement Order.¹⁴³

The Commission finds that the requirement that at least one-half of the directors of the CHX Board be Public 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 the remaining directors, other than the CEO of CHX, be Participant Directors and the manner in which such directors will be nominated and elected, together with the representation of CHX participants on key committees, satisfies the fair representation requirements in Section 6(b)(3) of the Act. The Commission notes, however, that after the demutualization trading privileges will be separated from corporate ownership of CHX and will be available exclusively through trading permits. Therefore, the Commission expects that trading permits will 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 will retain a voice in the administration of the affairs of CHX

¹⁴⁰ See CHX Rules, Article IV, Rules 2, 8, and 9.

¹⁴¹ See CHX Bylaws, Article II, Section 3.

¹⁴² See CHX Rules, Article IV, Rule 4.

¹⁴³ See note 64, supra, and accompanying text.

following the demutualization, including rulemaking and the disciplinary process, through participants' participation on various CHX committees.

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.¹⁴⁴ Depending on the results of the proposed rules, CHX may be required to make further changes to strengthen its governance structure. The Commission also believes that the CHX 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 CHX will have the dividend and other distribution rights of a shareholder in a Delaware stock corporation. The CHX Bylaws allow the CHX Board to declare dividends.¹⁴⁵ However, the CHX Bylaws further provide that any revenues received by CHX from regulatory fees or regulatory penalties will be applied to fund the legal and regulatory operations, including the surveillance and enforcement activities, of CHX and will not be used to pay dividends.¹⁴⁶ This limitation would preclude CHX from providing dividends derived from regulatory fees or penalties to the sole shareholder of CHX, *i.e.*, CHX Holdings. As a result, CHX Holdings would not be able to provide dividends derived from regulatory fees or penalties belonging to CHX to the shareholders of CHX Holdings. The

¹⁴⁴ See Proposed Rulemaking, *supra* note 101.

¹⁴⁵ See CHX Bylaws, Article XI, Section 2.

¹⁴⁶ For purposes of this provision, regulatory penalties include restitution and disgorgement of funds intended for customers. See CHX Bylaws, Article X, Section 5.

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 will ensure that the regulatory authority of CHX is not used improperly to benefit CHX Holdings and its shareholders.

IV. Accelerated Approval of Amendment No. 3

The Commission finds good cause for approving Amendment No. 3 to the proposal prior to the thirtieth day after date of notice of filing thereof in the Federal Register. Amendment No. 3 clarifies the proposal by confirming CHX's continuing participation in various NMS plans following the demutualization and by correcting a typographical error in the numbering of the articles of the CHX Bylaws. In addition, Amendment No. 3 strengthens the proposal by indicating that the staff of CHX will present to the Board of Directors of CHX Holdings for its approval a proposed new CHX Holdings Bylaws provision stating that CHX Holdings will take such action as is necessary to ensure that its officers, directors, and employees consent to the applicability of Article III, Section 3, and Article III, Section 5 of the CHX Holdings Bylaws with respect to CHX-related activities. Finally, Amendment No. 3 clarifies the language in the CHX's rules regarding the admission of members to be consistent with the language in the Act. Accordingly, the Commission finds that it is consistent with Sections 6(b)(5) and 19(b) of the Act to approve Amendment No. 3 on an accelerated basis.

V. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 3, including whether Amendment No. 3 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-CHX 2004-26 on the subject line.

Paper Comments:

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

All submissions should refer to File No. SR-CHX-2004-26. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule changes between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing will also be available for inspection and copying at the principal office of CHX. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. SR-CHX-2004-26 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁴⁷ that the proposed rule change (SR-CHX-2004-26), as amended, is approved, and Amendment No. 3 is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁴⁸

Margaret H. McFarland
Deputy Secretary

¹⁴⁷ 15 U.S.C. 78s(b)(2).

¹⁴⁸ 17 CFR 200.30-3(a)(12).