

SECURITIES AND EXCHANGE COMMISSION
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November 5, 2004

Self-Regulatory Organizations; Notice of Filing of a Proposed Rule Change by International Securities Exchange, Inc., Relating to Proposed Amendments to its Certificate of Incorporation and Constitution

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on October 22, 2004, the International Securities Exchange, Inc. (“Exchange” or “ISE”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III 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.

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

The Exchange is proposing to amend its Certificate of Incorporation and Constitution (also serving as the “Exchange’s bylaws”) in connection with its initial public offering (“IPO”). The proposed amendments, if approved, will become effective concurrently with the closing of the IPO. The proposed rule changes, including the proposed Amended and Restated Certificate of Incorporation (“Amended Certificate”) and the proposed Amended and Restated Constitution (“Amended Constitution”), collectively referred to herein as the “proposed rule change,” are available for viewing on the Commission’s Web site, <http://www.sec.gov/rules/sro.shtml>, and at ISE and the Commission.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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

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

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

1. Purpose

The Exchange proposes to amend its Certificate of Incorporation and Constitution in connection with its contemplated IPO of the Class A common stock, par value \$.01 per share (the “Class A Common Stock”), of the Exchange.³ The proposed amendments, if approved, will become effective concurrently with the IPO.⁴

Following the IPO, the Exchange will continue to operate as a registered “national securities exchange” under Section 6 of the Act,⁵ and will maintain its current regulatory authority over its members. All persons using the Exchange will continue to be subject to the Exchange’s rules. The Exchange will continue to interpret its rules to require that any revenues it receives from regulatory fees or regulatory penalties will be segregated and applied to fund the

³ Separately, the Exchange is also contemplating a reorganization into a holding company structure, the completion of which is contingent upon receipt of a favorable tax ruling from the Internal Revenue Service and Commission approval. The Exchange will separately file a rule change seeking approval of that reorganization. The Exchange currently anticipates that the reorganization will occur sometime following the IPO.

⁴ In connection with the proposed IPO, the Exchange filed a registration statement on Form S-1 with the Commission on July 2, 2004 (File No. 333-117145) (as amended from time to time, the “Registration Statement”).

⁵ 15 U.S.C. 78f.

legal, regulatory and surveillance operations of the Exchange and will not be used to pay dividends to the holders of Class A Common Stock.⁶ Many of the proposed changes to the Certificate of Incorporation and Constitution are intended to ensure that the IPO of the Exchange will not unduly interfere with or restrict the ability of the Exchange or the Commission to effectively carry out their respective regulatory oversight responsibilities under the Act and generally to enable the Exchange to operate in a manner that complies with the federal securities laws, including furthering the objectives of Section 6(b)(5) of the Act.⁷ However, some of the proposed changes to the Certificate of Incorporation and Constitution are intended to facilitate the IPO or otherwise relate to the Exchange's status as a public company following its IPO.

Current Capital Stock and Board Structure⁸

The Exchange currently has two classes of common stock, Class A Common Stock and Class B common stock, par value \$.01 per share ("Class B Common Stock").⁹ The Class A Common Stock has the traditional features of common stock, including voting, dividend and liquidation rights.¹⁰ Subject to certain limitations, holders of Class A Common Stock are entitled to vote on all matters submitted to stockholders for a vote.¹¹

⁶ The Exchange adopted this interpretation in connection with its demutualization in 2002. See infra, note 8.

⁷ 15 U.S.C. 78f(b)(5).

⁸ For a discussion of the Exchange's current capital and board structure, see Securities Exchange Act Release No. 45803 (April 23, 2002), 67 FR 21306 (April 30, 2002) (approving the restructuring of the Exchange from a limited liability company to a corporation and the demutualization of the Exchange's equity and trading interests and rights).

⁹ Some owners of shares of Class A Common Stock also own shares of Class B Common Stock. For a list of principal stockholders and their ownership of Class A and Class B Common Stock, see the Registration Statement, "Principal and Selling Stockholders."

¹⁰ The Amended Certificate will clarify that, as is currently the case, holders of shares of Class A Common Stock are entitled to all residual interests in the event of a liquidation, winding up or dissolution of the Exchange after payment of or provision for the

The Exchange has three series of Class B Common Stock, each series representing certain trading rights and privileges and limited voting rights. Ownership of the Class B Common Stock, Series B-1 (“Series B-1 Common Stock”), is a predicate to obtaining the trading rights and privileges associated with a Primary Market Maker.¹² Ownership of the Class B Common Stock, Series B-2 (“Series B-2 Common Stock”), is a predicate to obtaining the trading rights and privileges associated with a Competitive Market Maker.¹³ Ownership of the Class B Common Stock, Series B-3 (the “Series B-3 Common Stock”), is a predicate to obtaining the trading rights and privileges associated with an Electronic Access Member.¹⁴

obligations of the Exchange, any preferential amounts payable to holders of shares of preferred stock and amounts payable to the holders of any outstanding shares of Class B Common Stock.

¹¹ For the provisions relating to the Class A Common Stock, see Certificate of Incorporation, Article Fourth, Subdivision II(a). The holders of shares of Class A Common Stock are not entitled to vote with respect to the Core Rights (as defined in note 13, infra), the definition of “Core Rights”, or the election of Industry Directors (as defined herein).

¹² “Primary Market Makers” are market makers with significant responsibilities, including overseeing the opening of trading in their assigned options classes, providing continuous quotations in all of their assigned options classes, and handling customer orders that are not automatically executed. See Chapter 8 of the Exchange Rules and the Registration Statement, “Business,” for a discussion of the role of Primary Market Makers on the Exchange.

¹³ “Competitive Market Makers” are market makers that add depth and liquidity to the market and are required to provide continuous quotations in at least 60% of the options classes in their assigned group. See Chapter 8 of the Exchange Rules and the Registration Statement, “Business,” for a discussion of the role of Competitive Market Makers on the Exchange.

¹⁴ “Electronic Access Members” are broker/dealers that represent agency and proprietary orders on the Exchange, and cannot enter quotations or otherwise engage in market making activities on the Exchange. See Chapter 8 of the Exchange Rules and the Registration Statement, “Business,” for a discussion of the role of Electronic Access Members on the Exchange.

The holders of the Class B Common Stock are not entitled to receive dividends; rather, the holders of such stock are only entitled to receive an amount equal to the par value of each share of Class B Common Stock (i.e., \$.01) held upon the liquidation, dissolution or winding up of the Exchange.¹⁵ Also, such holders are entitled to vote on the election of directors representing the applicable series of Class B Common Stock, with each series of Class B Common Stock being entitled to elect two directors to the Board.

The owners of Series B-1 Common Stock and Series B-2 Common Stock are also entitled to vote on any change in, or amendment or modification to, the “Core Rights”¹⁶ or the definition of Core Rights. In such a case, the Exchange must obtain the approval of a majority of both the of Series B-1 Common Stock and the Series B-2 Common Stock, each voting as a separate class with respect to such action.¹⁷

¹⁵ The Amended Certificate will clarify that, as is currently the case, such amount will be paid before any proceeds from the liquidation, dissolution or winding up of the Exchange are paid to the holders of Class A Common Stock.

¹⁶ “Core Rights” as defined in Article Fourth, Subdivision II(a)(i) of the Certificate of Incorporation means any “increase in the number of authorized shares of the Series B-1 Stock or the Series B-2 Stock.”

¹⁷ For the provisions relating to the Class B Common Stock, see Certificate of Incorporation, Article Fourth, Subdivision II(b). The Amended Certificate proposes to make certain technical amendments to clarify that, as is currently the case, neither the holders of Class A Common Stock nor the holders of Series B-3 Common Stock are entitled to vote on the Core Rights. Additionally, the vote required with respect to the Core Rights would be increased from a majority of the votes cast by each of the Series B-1 Stock and Series B-2 Stock to a majority of the then outstanding shares of each of the Series B-1 Stock and Series B-2 Stock. See Amended Certificate, Article Fourth, Subdivision II(a) and (b). Any increase or decrease in the overall number of authorized shares of Class B Common Stock would require approval of the holders a majority of the outstanding shares of Class A Common Stock, voting as a separate class, and Series B-1 Stock and Series B-2 Stock, voting together as a separate class, any decrease in the number of authorized shares of Series B-1 Stock or Series B-2 Stock would require approval of the holders of a majority of the outstanding shares of Class A Common Stock, and any increase or decrease in the number of authorized shares of Series B-3 Stock would require approval of the holders of a majority of the outstanding shares of Class A Common Stock. The Exchange also may issue preferred stock in the future, the

The Board consists of 15 members, eight of whom are elected by the holders of the Class A Common stock (the “Non-Industry Directors”),¹⁸ six of whom are elected by the holders of the Class B Common Stock (the “Industry Directors”)¹⁹ and the Chief Executive Officer of the Exchange. In accordance with the current Certificate of Incorporation and Constitution of the Exchange, each director, other than the Chief Executive Officer, holds office for a term of two years.²⁰ The Chief Executive Officer holds office for a term of one year, or such earlier time as such person no longer serves as Chief Executive Officer. The directors, other than the Chief

terms of which would be determined by the Board, subject to Commission approval. See Certificate of Incorporation, Article Fourth, Subdivision I.

As agreed with ISE, the Commission staff made grammatical corrections and conformed the language in this footnote to the proposed rule text. Telephone conversation between Janet M. Kissane, Milbank, Tweed, Hadley & McCloy LLP, Counsel to ISE, and Jennifer C. Dodd, Attorney, Division of Market Regulation (“Division”), Commission on November 3, 2004.

¹⁸ Nominees for election to the Board to serve as Non-Industry Directors are currently made by the Exchange’s Corporate Governance Committee, on which all of the Non-Industry Directors serve. Stockholders may also nominate Non-Industry Director candidates for election to the Board by petition. See Section 3.10 of the Constitution.

¹⁹ Nominees for election to the Board to serve as Industry Directors are currently made by the Exchange’s Nominating Committee, which is not a committee of the Board, and is comprised of representatives of the holders of each series of Class B Common Stock. Stockholders may also nominate Industry Director candidates for election to the Board by petition. See Section 3.10 of the Constitution.

²⁰ The Amended Certificate would clarify that the Board is authorized to fill any vacancies on the Board. See Article Fourth, Subdivision II(a)(i) and (b)(v)(A). The Amended Certificate would also provide that directors may only be removed for cause by the stockholders to the extent permitted under applicable law, and not by a vote of two-thirds of the directors as is currently the case. See Article Fifth, paragraph (b).

As agreed with ISE, the Commission staff revised this footnote to differentiate between ISE’s current and proposed rules. Telephone conversation between Janet M. Kissane, Milbank, Tweed, Hadley & McCloy LLP, Counsel to ISE, and Jennifer C. Dodd, Attorney, Division, Commission, on November 3, 2004.

Executive Officer, are divided into two classes, designated as Class I and Class II directors.²¹ At each annual meeting of stockholders, the successors of the class of directors whose term expires at that meeting will be elected to hold office for a term expiring at the annual meeting of stockholders held in the second year following the year of their election, and until their successors are elected and qualified. Directors, other than the Chief Executive Officer, may not hold office for more than three consecutive terms.²²

In addition, the Exchange currently has a Finance & Audit Committee, a Corporate Governance Committee and a Compensation Committee, all of which are governed by charters.²³

Proposed Amendments to Certificate of Incorporation and Constitution

The Exchange proposes to amend its current Certificate of Incorporation and Constitution to:

- increase the number of authorized shares of Class A Common Stock from 5,000,000 to 150,000,000;
- remove the term limits of the Non-Industry Directors;
- adopt certain limitations on the ownership and voting of shares of Class A Common Stock and of Class B Common Stock;

²¹ For a list of the Exchange's current directors and their respective classes, see Registration Statement, "Management." As currently and prospectively constructed, each class will be composed of half of the Non-Industry Directors and half of each of the Series B-1, Series B-2 and Series B-3 directors.

²² For the provisions relating to the Board, see Certificate of Incorporation, Article Fifth and Constitution, Section 3.2.

²³ For a discussion of these committees and their responsibilities, see Registration Statement, "Management." The Board designated these committees pursuant to its authority under Section 5.1 of the Constitution, though the Corporate Governance and Compensation Committees are not specifically designated in the current Constitution itself.

- require the Board to consider applicable requirements of the Act in managing the business and affairs of the Exchange;
- clarify that the Exchange has a Corporate Governance Committee and Compensation Committee, and that these committees, as well as the Finance & Audit Committee of the Exchange, are governed by charters;
- adopt certain antitakeover provisions, including with respect to the nomination of Non-Industry Directors by the holders of Class A Common Stock; and
- reduce the vote of the holders of Class A Common Stock required to amend certain provisions of the Amended Constitution from two-thirds of the outstanding shares of Class A Common Stock to a majority of such shares.²⁴

(1) Increase in Number of Authorized Shares of Class A Common Stock

The Exchange proposes that the number of authorized shares of Class A Common Stock be increased from 5,000,000 to 150,000,000.²⁵ This increase will provide the Board with the flexibility to declare a stock dividend that, in the opinion of the underwriters of the IPO, will be sufficient to result in an appropriate market price per share of the Class A Common Stock. The increase in the number of authorized shares of Class A Common Stock will also provide shares: (1) to be offered in the IPO, as well as additional shares that can be used for future acquisitions

²⁴ The Exchange is also proposing to correct certain typographical and grammatical errors, eliminate outdated or irrelevant references and make certain immaterial changes to the Certificate of Incorporation and Constitution. Such changes include, among others, the flexibility to provide notice of Board meetings by several alternate means (see Section 3.6 of the Amended Constitution); the empowerment of the Board (instead of the Chief Executive Officer) to appoint and remove officers (see Sections 4.2 and 4.3 of the Amended Constitution); the consolidation of the positions of Chief Executive Officer and President (see Section 4.1 of the Amended Constitution); and the prohibition on ownership of shares of Class B Common Stock by officers of the Exchange (see Section 4.5 of the Amended Constitution).

²⁵ See Amended Certificate, Article Fourth.

that may be approved by the Board (and by Class A stockholders to the extent required by the rules of the marketplace for the shares of Class A Common Stock); and (2) to be used for stock options, stock purchase and other equity compensation plans that are approved by the Board (and by Class A stockholders to the extent required by the rules of the marketplace for the shares of Class A Common Stock).

(2) Change in the Term Limits of the Board

In order to maintain continuity with respect to the Non-Industry Directors during the transition of the Exchange to a public company, the Exchange proposes that the three-term limit (a total of six years of service) currently in the Certificate of Incorporation and Constitution with respect to all directors, other than the Chief Executive Officer, be amended to apply only to Industry Directors.²⁶ Currently, all Non-Industry Directors face term limits that would result in a total turn-over of such directors over a two-year period. The Exchange believes that removing term limits for Non-Industry Directors will allow the Board to continue to function with experienced Non-Industry Directors, thereby facilitating a smooth transition to a public company structure. Once it becomes a public company, the Exchange will address term limits for Non-Industry Directors through amendments to its Corporate Governance Principles.²⁷

²⁶ See Amended Certificate, Article Fifth, and Amended Constitution, Section 3.2.

²⁷ Because the Exchange's Board believes it is important that following the Exchange's IPO there be a smooth transition from its original Non-Industry Directors to their successors, the Exchange's Board has adopted Corporate Governance Principles providing that it may be appropriate for up to four of the eight original Non-Industry Directors to serve one additional term. This would result in a transition to new Non-Industry Directors over a four-year period, rather than a two-year period. The Corporate Governance Committee will determine whether, and how, to provide for this phased transition.

(3) Ownership and Voting Limitations with Respect to the Exchange's Capital Stock²⁸

(a) Ownership Limitations

Under the proposed Amended Certificate, no "Person"²⁹ either alone or together with its "Related Persons"³⁰ would be permitted to own, directly or indirectly, of record or

²⁸ The ISE noted that there was a typographical error appearing in Article Fourth, Subdivision III(c)(vii) of the Amended Certificate of Incorporation. The word "prices" should replace the word "process" in the definition of the term "Market Price" in the second paragraph of Article Fourth, Subdivision III(c)(vii) of the Amended Certificate. ISE agrees to correct this error in an amendment to the rule filing to be filed after ISE's stockholders have approved the proposed Amended Certificate. Telephone conversation between Janet M. Kissane, Milbank, Tweed, Hadley & McCloy LLP, Counsel to ISE, and Jennifer C. Dodd, Attorney, Division, Commission, on November 1, 2004.

Currently, with the exception of certain exemptions for Founders (as defined in the Constitution), no holder of Class A Common Stock, together with any affiliate (as defined in the Constitution), shall vote or give any proxy in relation to a vote with respect to any shares owned in excess of 20 percent of the Class A Common Stock, and no holder of Class B Common Stock, together with any affiliate (as defined in the Constitution) may own more than 20 percent of Series B-1 Stock or Series B-2 Stock and no Member (as defined in the Constitution), together with any affiliate (as defined in the Constitution), may be approved to exercise trading rights associated with more than 20 percent of Series B-1 Stock or Series B-2 Stock. Certificate of Incorporation, Article Fourth, Subdivision II(a)(iv) and Constitution, Article XIV. See supra, note 8.

As agreed with ISE, the Commission staff revised this footnote to clarify ISE's current ownership and voting limitations. Telephone conversation between Janet M. Kissane, Milbank, Tweed, Hadley & McCloy LLP, Counsel to ISE, and Jennifer C. Dodd, Attorney, Division, Commission, on November 3, 2004.

²⁹ "Person" as defined in Article Fourth, Subdivision III of the Amended Certificate means any "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."

³⁰ "Related Person" as defined in Article Fourth, Subdivision III of the Amended Certificate means "(1) with respect to any Person, all 'affiliates' and 'associates' of such Person (as such terms are defined in Rule 12b-2 under the Act); (2) with respect to any Person constituting a Member, any broker or dealer with which such Member is associated; and (3) 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 [Exchange]."

beneficially,³¹ shares of capital stock (whether common or preferred stock) of the Exchange (1) constituting more than 40 percent of the then outstanding shares of any class or series of capital stock (the “40 percent ownership limitation”); or (2) constituting more than 20 percent of the then-outstanding shares of any class or series of capital stock if such holder is also a member of the Exchange (that is, a Primary Market Maker, Competitive Market Maker or Electronic Access Member) (the “20 percent member ownership limitation”).³²

Furthermore, any Person, alone or together with its Related Persons, who owns more than five percent of the then outstanding shares of any class or series of the Exchange’s capital stock will be required to provide certain information to the Board and will have an ongoing obligation to update such information.³³ The Exchange believes these provisions will enable it to obtain

³¹ Beneficial ownership (and derivative or similar words) as defined in Article Fourth, Subdivision III of the Amended Certificate has the meaning set forth in Regulation 13D-G under the Act. The Exchange believes that use of this existing Commission definition will aid it in verifying the ownership of its capital stock by monitoring filings on Schedules 13D and 13G by its stockholders.

³² See Amended Certificate, Article Fourth, Subdivisions III(a)(i) and (a)(ii).

³³ Article Fourth, Subdivision III(a)(iii) of the Amended Certificate requires that any Person, either alone or together with its Related Persons, that at any time owns five percent or more of the then outstanding shares of any class or series of capital stock of the Corporation, that has the right by its terms to vote in the election of members of the Board, must, immediately upon so owning five percent or more, give the Board written notice of such ownership stating: (1) such Person’s full legal name; (2) such Person’s title or status and the date on which such title or status was acquired; (3) such Person’s approximate ownership interest in the Exchange; and (4) whether such Person has the power, directly or indirectly, to direct the management or policies of the Exchange, whether through ownership of securities, by contract or otherwise. Each such Person must notify the Board of any changes in ownership except when such change is an increase or decrease of less than one percent in the ownership percentage so reported (such increase or decrease to be measured cumulatively from the amount shown on the last such report) unless any increase or decrease of less than 1 percent results in such Person so owning more or less than 20 percent or more than 40 percent of the shares of any class or series of capital stock then outstanding (at a time when such Person so owned less than such percentages), as the case may be. The Exchange will also consider, among other things, any filings made with the Commission under Section 13(d) and Section 13(g) of the Act by such Person and its Related Persons and will aggregate all

information necessary to determine whether there has been a violation of the voting or ownership limitations described herein.

If any Person, alone or together with its Related Persons, purports to sell, transfer, assign or pledge any shares of capital stock in the Exchange in violation of the ownership limits, the Exchange would apply standard corrective procedures used by public companies with similar ownership limits. Specifically, any such sale, transfer, assignment or pledge would be void, and that number of shares in excess of the ownership limitation would be deemed to have been transferred to the Exchange, as special trustee of a charitable trust, for the exclusive benefit of a charitable beneficiary to be determined by the Exchange.³⁴ These corrective procedures would also apply if there is any other event causing any holder of capital stock to exceed the ownership limits, such as a repurchase of shares by the Exchange.³⁵ The automatic transfer would be deemed to be effective as of the close of business on the business day prior to the date of the violative transfer or other event.³⁶

shares owned or voted by such Person and its Related Persons deemed to be beneficially owned by them. For information on ISE's current principal stockholders, see also the Registration Statement, "Principal and Selling Stockholders."

³⁴ See Article Fourth, Subdivision III(c) of the Amended Certificate. The Exchange may also determine to appoint as special trustee an entity unaffiliated with the Exchange and any Person or its Related Persons owning excess shares. See Article Fourth, Subdivision III(c)(ii) of the Amended Certificate.

³⁵ Any holders owning excess shares as a result of any event other than a sale, transfer, assignment or pledge would cease to have rights in such shares.

³⁶ As agreed with ISE, the Commission staff revised this sentence to clarify that the effective date in the case of an "other event" would also be as of the close of business on the business day prior to the date of the event. Telephone conversation between Janet M. Kissane, Milbank, Tweed, Hadley & McCloy LLP, Counsel to ISE, and Jennifer C. Dodd, Attorney, Division, Commission, on November 3, 2004.

The special trustee of the trust would be required to sell the excess shares to a person whose ownership of shares is not expected to violate the ownership limitations. The net proceeds of the sale would be distributed first, to the original prohibited transferee or holder, who would receive the lesser of (1) the price per share received by the Exchange from the transfer of the excess shares (2) the price per share the prohibited transferee or holder paid for the shares in the violative transfer, or (3) if the prohibited transferee or holder did not give value for such excess shares, a price per share equal to the market price for the excess shares on the date of the purported transfer or other event that resulted in the excess shares, except that in the case of a prohibited holder holding excess shares solely as the result of an action or event by the Exchange (such as an action resulting in a reduction in the number of outstanding shares), such prohibited holder would receive the greater of (1) or (3) above for the excess shares. After such distribution, any proceeds in excess of the amount payable to the prohibited transferee or holder would be payable to the charitable beneficiary. Prior to the sale, the special trustee would be entitled to receive, in trust for the beneficiary, all dividends and other distributions paid by the Exchange with respect to the excess shares, and also would be entitled to exercise all voting rights with respect to the excess shares.³⁷

In addition, excess shares (including any shares deemed to be excess shares by reason of a reduction in outstanding shares caused by a purchase of excess shares by the Exchange) would be deemed to have been offered for sale to the Exchange.³⁸ The Exchange shall have the right to

³⁷ Any excess shares held by the special trustee would be entitled to vote and deemed outstanding for purposes of determining a quorum or minimum vote required for the transaction of any business at any stockholders' meeting. Telephone conversation between Janet M. Kissane, Milbank, Tweed, Hadley & McCloy LLP, Counsel to ISE, and Jennifer C. Dodd, Attorney, Division, Commission, on November 4, 2004.

³⁸ The excess shares would be deemed to be offered to the Exchange at a price per share equal to the lesser of (1) the price per share the purported transferee or holder paid for the

accept such offer until the special trustee has sold the shares held in the charitable trust.³⁹ If the Exchange accepts such offer, it would determine the additional number of shares (if any) that become excess shares by reason of the reduction in outstanding shares caused by the Exchange's purchase of excess shares (whether any Person, either alone or together with its Related Persons, holds such excess shares in connection with a purported transfer or is deemed to hold such excess shares as a result of the Exchange's purchase of excess shares) and take all action reasonably necessary to ensure that such additional excess shares are added to the initial number of excess shares subject to the Exchange's corrective procedures.⁴⁰

As applied to the current outstanding capital stock of the Exchange, the 40 percent ownership limitation would apply to any holder of Class A Common Stock, other than an Exchange member. The 20 percent member ownership limitation would apply to any such member, and would limit to that amount such holder's ownership of each of the Class A

shares in the purported transfer or other event that resulted in excess shares (or in the case of an event not involving any payment, the market price at the time of the transfer or other event) and (2) the market price of the shares on the date the Exchange accepts such offer. The Exchange may accept the offer in whole or in part.

³⁹ See Article Fourth, Subdivision III(c)(vi) of the Amended Certificate.

⁴⁰ The Exchange believes that this mechanism will prevent repeated violations (i.e., an endless loop) of the ownership provisions in connection with repurchases by the Exchange (both generally and with respect to excess shares). In practice, the Exchange would structure repurchases, if any, in a manner designed not to trigger any new violations of the ownership restrictions set forth in Article Fourth, Subdivision III, or if triggered, to include such new violations in its repurchase. For example, if there were 100 shares of Class A Common Stock outstanding and two members of the Exchange (Member A and Member B) each currently owned 20% of the outstanding shares of Class A Common Stock, and Member A purchased 5 shares of Class A Common Stock (increasing his ownership to 25%), the Exchange could either (a) repurchase the 5 shares from Member A and permit the special trustee to sell one share from Member A and one share from Member B to third parties or (b) repurchase 9 shares of Class A Common Stock from Member A and 3 shares of Class A Common Stock from Member B, all of which would be deemed excess shares pursuant to the mechanism described above.

Common Stock and each Series of Class B Common Stock. The Exchange represents that currently no Person, either alone or together with its Related Persons, owns more than 40 percent of the outstanding shares of Class A Common Stock, and no member, either alone or together with its Related Persons, owns more than 20 percent of the outstanding shares of Class A Common Stock or any series of Class B Common Stock.⁴¹

(b) Voting Limitations

The proposed rule change also would prohibit any Person, either alone or together with its Related Persons, from voting, or causing the voting of, shares of capital stock of the Exchange (or giving a consent or proxy with respect to shares) representing more than 20 percent of the voting power of any class or series of capital stock (the “20 percent voting limitation”).⁴² In the event that a stockholder purports to vote, grant any proxy or enter into any other agreement for the voting of shares that would violate the 20 percent voting limitation, such vote, proxy or

⁴¹ As agreed with ISE, the Commission staff revised this sentence to clarify that currently, no Person or member exceeds the proposed ownership limitations, including when such Person’s or member’s interest is aggregated with the interests of their Related Persons. Telephone conversation between Janet M. Kissane, Milbank, Tweed, Hadley & McCloy LLP, Counsel to ISE, and Jennifer C. Dodd, Attorney, Division, Commission, on November 3, 2004.

⁴² The 20 percent voting limitation also would prohibit any Person, either alone or together with its Related Persons, from entering into any agreement, plan or other arrangement with another Person that would result in the shares of any class or series of capital stock that are subject to such agreement, plan or arrangement not being voted on any matter or matters where the effect of such agreement, plan or other arrangement would be to enable any Person to vote, possess the right to vote or cause the voting of shares of any class or series of capital stock that would, as a result thereof, represent more than 20 percent of any class or series of capital stock available to be voted. The Amended Certificate and the Amended Constitution clarify that only those shares entitled to vote would be counted for purposes of determining a quorum or a minimum vote required for the transaction of any business at any stockholders’ meeting, including, without limitation, when specified business is to be voted on by a class or a series voting as a class. See Article Fourth, Subdivision III(b)(iii) of the Amended Certificate and Section 2.4 of the Amended Constitution. Telephone conversation between Janet M. Kissane, Milbank, Tweed, Hadley & McCloy LLP, Counsel to ISE, and Jennifer C. Dodd, Attorney, Division, Commission on November 4, 2004.

agreement would not be honored by the Exchange to the extent that the 20 percent voting limitation provision would be violated. The 20 percent voting limitation will not apply to any solicitation of any revocable proxy from any stockholder of the Exchange by the Exchange or by any stockholder of the Exchange pursuant to Regulation 14A under the Act.⁴³

(c) Board Notice Regarding Certain Limitations

The proposed rule change will impose certain requirements on Persons to give notice of events regarding ownership that would exceed the proposed ownership or voting threshold. Specifically, any Person intending to exceed these ownership or voting limitations must provide the Board with written notice of the fact at least 45 days (or such shorter period to which the Board expressly consents) prior to either the proposed acquisition of shares of the proposed exercise of voting rights, as the case may be.⁴⁴

(d) Board Waiver of Certain Limitations

The Board may adopt a resolution specifying that it has determined that the 40 percent ownership limitation or the 20 percent voting limitation or both should be waived if it finds that such waiver (1) will not impair the ability of the Exchange to carry out its functions and responsibilities as an “exchange” under the Act; (2) is otherwise in the best interests of the Exchange and its stockholders; (3) will not impair the ability of the Commission to enforce the Act; and (4) will apply to a Person and its Related Persons who are not subject to any applicable “statutory disqualification” (within the meaning of Section 3(a)(39) of the Act). In the event of such a finding, the waiver would take the form of an amendment to the Constitution, which

⁴³ See Amended Certificate, Article Fourth, Subdivision III(b).

⁴⁴ See Amended Certificate, Article Fourth, Subdivisions III(a)(i)(B) and (b)(i).

would not be effective until approved by the Commission. The Board may not waive the 20 percent member ownership limitation.⁴⁵

(e) Elimination of Founders Exemption

The Amended Certificate also eliminates the “founders exemption” that permitted the original founders of the Exchange to own shares of Class A Common Stock and Class B Common Stock in excess of the stated limits for a certain period of time.⁴⁶ Because all of the founders have fallen below the ownership thresholds in place, the exemption is no longer necessary.

(f) Effects of Ownership and Voting Limits

The Exchange believes that these ownership and voting limitations, taken together, will serve to prevent any stockholder, or group of stockholders acting together, from exercising undue control over the operation of the Exchange. The Exchange believes that these limitations will prohibit any Person, either alone or with its Related Persons, from having the power to control a substantial number of outstanding votes without Commission review. This should limit the ability of any such Persons from taking actions that may be adverse to the Exchange’s or the Commission’s regulatory oversight responsibilities. The Exchange also believes that these provisions serve to protect the integrity of the Exchange’s and the Commission’s regulatory oversight responsibilities and allow the Commission to review, subject to public notice and comment, the acquisition of substantial voting power by any stockholder or group of stockholders.

⁴⁵ See Amended Certificate, Article Fourth, Subdivisions III(a)(i)(B) and (b)(i).

⁴⁶ The founders exemption, which applied to persons or entities that purchased LLC memberships directly from the Exchange on or prior to August 1, 1998 and extended to May 26, 2010, was approved by the Commission in connection with the Exchange’s demutualization in 2002. See *supra*, note 8.

(4) Exchange Act Obligations

The Exchange proposes that the Amended Certificate provide that the Board shall, in managing the affairs and business of the Exchange, consider requirements applicable to its registration and operation as a national securities exchange under the Act, including without limitation, the requirements that (a) the rules of the Exchange be designed to protect investors and the public interest, and (b) the Exchange be so organized and have the capacity to carry out the purposes of the Act and (subject to such exceptions as are set forth in the Act or the rules and regulations thereunder) to enforce compliance by its members and persons associated with its members with the provisions of the Act, the rules and regulations thereunder, and the rules of the Exchange. These provisions in the Amended Certificate shall not be construed to create the basis for any cause of action against any director, and no director shall be liable, by virtue of these provisions, for such director's consideration or failure to consider the matters referred to therein.⁴⁷

(5) Board Committees

The Exchange proposes that the Amended Constitution include provisions relating to specific Board committees in connection with the contemplated listing of the Exchange on a national securities exchange or national securities association following the IPO. In particular, the Exchange proposes to add the Corporate Governance Committee and the Compensation Committee to its list of specifically designated Board committees in the Amended Constitution, and to require that each of the Finance & Audit, Corporate Governance and Compensation Committees be governed by charters.⁴⁸

⁴⁷ See Amended Certificate, Article Twelfth.

⁴⁸ See Amended Constitution, Sections 5.4, 5.5 and 5.6. The Exchange currently has a Corporate Governance and Compensation Committee, designated by the Board pursuant

(6) Certain Antitakeover Provisions

The Exchange proposes that the Amended Certificate, along with the Amended Constitution, include certain antitakeover provisions for protection against certain types of coercive corporate takeover practices and inadequate takeover bids. The proposed provisions relate to special meetings of stockholders and the required stockholder vote with respect to certain actions. In view of the limitations on ownership and voting described above, the provisions proposed do not include a “poison pill” arrangement. The Board does, however, maintain the authority under its current organizational documents to adopt such an arrangement with Commission approval.

(a) Elimination of a Stockholder’s Right to Call a Special Meeting

The Amended Certificate and Amended Constitution deny the Exchange’s stockholders the right to call a special meeting of stockholders, and provide that only the Chairman of the Board or a majority of the Board may call a special meeting of the stockholders.⁴⁹

(b) Advance Notice Requirement for Stockholder Proposals

The Amended Constitution establishes advance notice procedures with regard to stockholder proposals relating to the nomination of candidates for election as Non-Industry Directors or new business to be brought before meetings of stockholders. The Exchange’s advance notice requirement does not apply to nominations of Industry Director nominees for election to the Board who are nominated by the Exchange’s Nominating Committee (which is not a committee of the Board) or stockholders pursuant to Sections 3.10(a) and 5.3(c) of the

to its authority under Section 5.1 of the Constitution; the Amended Constitution will specifically provide for these committees.

⁴⁹ See Amended Certificate, Article Eighth and Amended Constitution, Section 2.2.

Constitution. Following the IPO, pursuant to the Exchange's Corporate Governance Committee charter and Section 3.10(b) of the Constitution, the Corporate Governance Committee would nominate for election to the Board a slate of Non-Industry Directors pursuant to Section 2.7(a) and (b). These procedures provide that notice of stockholder proposals must be given in writing to the Secretary of the Exchange prior to the meeting at which the action is to be taken.⁵⁰

Generally, such notice would have to be received at the principal executive offices of the Exchange not fewer than 60 days nor more than 90 days prior to the meeting. Any such notice must comply with certain additional informational and descriptive requirements set out in the Amended Constitution.⁵¹ Additionally, stockholders shall comply with all applicable

⁵⁰ With the institution of Section 2.7 of the Amended Constitution, Non-Industry Director nominations by Class A stockholders will likely be required to be made in advance of the selection or announcement of a slate of Non-Industry Director candidates by the Corporate Governance Committee. Currently, Non-Industry Director nominations by Class A stockholders must be made in advance of the stockholders' meeting, but generally after the Corporate Governance Committee announces its slate.

⁵¹ In particular, the notice must set forth (1) as to each person whom the stockholder proposes to nominate for election or reelection as a director all information relating to such person that is required to be disclosed in solicitations of proxies for election of directors, or is otherwise required, in each case pursuant to Regulation 14A under the Act, including such person's written consent to being named in the proxy statement as a nominee and to serving as a director if elected and a statement that such nominee complies with the requirements set forth in the Amended Certificate; (2) as to any other business that the stockholder proposes to bring before the meeting, a brief description of the business desired to be brought before the meeting, the reasons for conducting such business at the meeting and any material interest in such business of such stockholder and the beneficial owner, if any, on whose behalf the proposal is made; and (3) as to the stockholder giving the notice and the beneficial owner, if any, on whose behalf the nomination or proposal is made (i) the name and address of such stockholder, as they appear on the Corporation's books, and of such beneficial owner and (ii) the class and number of shares of the Corporation which are owned beneficially and of record by such stockholder and such beneficial owner. See Amended Constitution, Section 2.7.

requirements of the Act and the rules and regulations thereunder with respect to any proposals submitted pursuant to the advance notice procedures.⁵²

The Exchange's advance notice requirement will not apply to nominations of Industry Director nominees for election to the Board who are nominated by the Exchange's Nominating Committee (which is not a committee of the Board) or stockholders pursuant to Sections 3.10(a) and 5.3(c) of the Constitution. Following the IPO, the Non-Industry Directors would be nominated by the Corporate Governance Committee or Class A stockholders pursuant to Sections 2.7(a) and (b) and 3.10(b) of the constitution.

(c) Increase in Required Vote for Certain Stockholder Actions

In addition to other currently required items, the Amended Certificate would require a two-thirds vote of stockholders to amend, repeal or adopt any provisions inconsistent with (1) the limitations on ownership and voting of capital stock contained in the Amended Certificate, as described above in Section 3 ("Ownership and Voting Limitations with Respect to the Exchange's Capital Stock"), (2) the provision in the Amended Certificate providing the Board with the authority to create and issue rights under a rights plan, and (3) the advance notice provision contained in the proposed Amended Constitution.⁵³

(7) Reduction in Votes Required to Approve Amendments to the Amended Constitution

The Exchange proposes that the current two-thirds vote of all of the outstanding shares of Class A Common Stock be reduced to a majority vote of such shares in order to amend certain provisions of the Amended Constitution that are not subject to a required two-thirds vote under

⁵² See Amended Constitution, Section 2.7. Previously, Section 2.7 of the Constitution addressed stockholder record dates; that matter is now proposed to be addressed in Section 7.4 of the Amended Constitution.

⁵³ See Amended Certificate, Article Seventh.

the Amended Certificate. Such amendments to the current Constitution may be accomplished by a two-thirds vote of the stockholders or by action of the Board. The two-thirds vote requirement for an amendment to the current Constitution was deemed appropriate for a private securities exchange owned primarily by its members, in order to assure substantial agreement as to changes in significant aspects of corporate governance. However, the Exchange believes that the continuation of such a high vote requirement, in the context of a publicly traded company with a widely diverse stockholder base and the likelihood of lower voting participation, makes it unduly difficult to effect any necessary changes by stockholder vote to these corporate governance provisions in the future.⁵⁴

(8) Confidential Information and Books and Records

Pursuant to the Amended Certificate, all confidential information pertaining to the self-regulatory function of the Exchange (including but not limited to disciplinary matters, trading data, trading practices and audit information) contained in the books and records of the Exchange shall: (1) not be made available to any Persons other than to those officers, directors, employees and agents of the Exchange that have a reasonable need to know the contents thereof and to the Commission; and (2) be retained in confidence by the Exchange and the officers, directors, employees and agents of the Exchange; and (3) not be used for any commercial purposes.⁵⁵

In addition, the ISE's books and records shall be maintained within the United States.⁵⁶

⁵⁴ See Amended Certificate, Article Seventh and Amended Constitution, Section 11.1.

⁵⁵ See Amended Certificate, Article Thirteenth.

⁵⁶ See Amended Constitution, Section 1.3.

2. Statutory Basis

The basis under the Act for this proposed rule change is the requirement under Section 6(b)(1) of the Act⁵⁷ that an exchange be so organized and have the capacity to be able to carry out the purposes of the Act and to comply, and (subject to any rule or order of the Commission pursuant to Section 17(d) or 19(g)(2) of the Act⁵⁸) to enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulations thereunder, and the rules of the exchange, and the requirement under Section 6(b)(5) of the Act⁵⁹ that an exchange have rules that, among other things, are designed to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest.

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

The proposed rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

The Exchange has not solicited, and does not intend to solicit, comments on this proposed rule change. The Exchange has not received any unsolicited written comments from members, participants or others.

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds

⁵⁷ 15 U.S.C. 78f(b)(1).

⁵⁸ 15 U.S.C. 78q and 15 U.S.C. 78s.

⁵⁹ 15 U.S.C. 78f(b)(5).

such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

- (A) by order approve such proposed rule change; or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

Certain aspects of this proposed rule change have been approved by the Board on July 22, 2004, and by the Exchange's stockholders on August 16, 2004. The remaining aspects of this proposed rule change are scheduled to be approved by the Board and stockholders as soon as practicable. To the extent necessary, the Exchange hereby consents to an extension of the time period specified in Section 19(b)(2) of the Act until at least thirty-five (35) days after the Exchange has filed an appropriate amendment setting forth the completion of all such action under the Certificate of Incorporation and Constitution of the Exchange with respect to this proposed rule change.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. 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 No. SR-ISE-2004-29 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 Number SR-ISE-2004-29. 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 Commissions 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 available for inspection and copying at the principal office of the ISE. 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-ISE-2004-29 and should be submitted by [insert date 21 days from the date of publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁶⁰

Margaret H. McFarland
Deputy Secretary

⁶⁰ 17 CFR 200.30-3(a)(12).