

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-49718; File No. SR-PCX-2004-08)

May 17, 2004

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

I. Introduction

On February 10, 2004, the Pacific Exchange, Inc. ("PCX" 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 convert the ownership of the existing Exchange from a non-stock, not-for-profit membership corporation into a for-profit stock corporation, and to convert the options trading rights of current PCX seats to Option Trading Permits. On March 29, 2004, the proposed rule change was published for comment in the Federal Register.³ The Commission received one comment letter in response to the proposed rule change.⁴ On May 14, 2004, PCX filed Amendment No. 1 to the proposed rule change.⁵ This order approves the proposed rule change, as amended.

II. Description of Proposed Rule Change

The current PCX, a Delaware non-stock, not-for-profit corporation, proposes a plan to "demutualize," whereby it will be reorganized as a subsidiary (the "reorganized PCX" or

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 49451 (March 19, 2004), 69 FR 16305 ("Notice").

⁴ See Letter from John A. Brown, Pacific Exchange Member, to Jonathan G. Katz, Secretary, Commission, dated April 7, 2004 ("Brown Letter").

⁵ See Letter from Steven B. Matlin, Regulatory Policy, PCX, to Nancy J. Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated May 13, 2004 ("Amendment No. 1"). See Section IV infra for a description of Amendment No. 1.

"reorganized Exchange")⁶ of a for-profit stock corporation, the stockholders of which initially will be the current owners of the outstanding authorized memberships of the current Exchange.⁷ To effect the demutualization, a newly-formed Delaware stock corporation, PCX Holdings, Inc. ("PCX Holdings"), will become a holding company for the reorganized Exchange and its other operating subsidiaries. PCX Holdings has formed a wholly-owned subsidiary solely for the purpose of completing the merger, which will merge with and into the current PCX. This surviving entity, the reorganized Exchange, will be a wholly-owned subsidiary of PCX Holdings. The reorganized PCX, a non-stock corporation, will operate the options business of the current PCX and will have a separate Board of Directors. The reorganized PCX will retain the self-regulatory organization function for the options business as well as for its equities business subsidiary, PCX Equities, Inc. ("PCX Equities" or "PCXE"). According to the Exchange, the proposed demutualization will not affect PCXE's operations, governance structure, or rules.

Prior to the merger, the current Exchange will undergo a recapitalization whereby it will convert each of its 552 outstanding authorized memberships into two separate components: (1) a Class A membership interest representing each member's ownership interest in the current Exchange; and (2) a Class B membership interest representing options trading privileges on the current Exchange. As a result of the demutualization, current PCX members will receive one thousand (1,000) shares of voting common stock in PCX Holdings in exchange for their Class A

⁶ In this Order, where the context requires differentiation between the PCX prior to the demutualization and the PCX after the demutualization, the existing membership organization is referred to as the "current PCX" or "current Exchange," and the new entity, which will be a wholly-owned subsidiary of PCX Holdings, is referred to as the "reorganized PCX" or the "reorganized Exchange."

⁷ The proposed rule change, as amended, includes: the Rules for the reorganized Exchange; the Certificate of Incorporation for PCX Holdings; the Bylaws for PCX Holdings; the Certificate of Incorporation for the reorganized Exchange; the Bylaws for the reorganized Exchange; and the deletion of the Constitution and the Certificate of Incorporation of the current Exchange.

membership interest and, in addition, will receive an Options Trading Permit (“OTP”)⁸ in the reorganized PCX in place of the Class B membership interest.

The common stock of PCX Holdings will represent an equity interest in the company and will have the traditional features of common stock, including dividend, voting, and liquidation rights.⁹ Holders of common stock will be entitled to vote on all matters submitted to the stockholders for a vote, including the election of the Board of Directors of PCX Holdings, extraordinary transactions such as a merger, consolidation, dissolution or sale of all or substantially all of the assets of PCX Holdings, and certain changes to the Bylaws of PCX Holdings.

According to the Exchange, by restructuring its business as a stock corporation with business control and management vested in a Board of Directors, the entity will have greater flexibility to develop and execute strategies designed to improve its competitive position than it has under the current membership-cooperative structure. Further, the Exchange anticipates that by restructuring as a stock corporation, PCX management will be better able to respond quickly to competitive pressures and to make changes to its operations as market conditions warrant, without diminishing the integrity of its regulatory programs. Following the completion of the demutualization, PCX believes that the holders of common stock of PCX Holdings will retain, through their ownership of stock, their economic interest in its operating subsidiaries and

⁸ See PCX Rule 1.1(p) (definition of "OTP"; see also PCX Rule 1.1(q) (definition of "OTP Holder") and PCX Rule 1.1(r) (definition of "OTP Firm").

⁹ According to the Exchange, it does not currently anticipate that PCX Holdings will pay dividends on its common stock in the immediate future. The Exchange represents that, in the event that a dividend is declared, any revenues received by the reorganized PCX from regulatory fees or regulatory penalties will be applied only to fund the legal, regulatory, and surveillance operations of the reorganized PCX, and will not be used to pay dividends to the holders of PCX Holdings common stock.

ultimately will benefit from any improvement in the financial health of these entities resulting from the demutualization.

A. Corporate Structure

1. PCX Holdings, Inc.

Following the completion of the demutualization, PCX Holdings will be a for-profit stock corporation and will act as a holding company for the reorganized Exchange and its operating subsidiaries. PCX Holdings will provide management and corporate support to its subsidiaries. PCX Holdings, as the sole member of the reorganized PCX, will have the right to elect the Board of Directors of the reorganized PCX¹⁰ and will have the right to vote on any proposal to merge the reorganized PCX with a third party, to sell a significant amount of the reorganized Exchange's assets to a third party, or to dissolve or liquidate the reorganized PCX. The Certificate of Incorporation and Bylaws of PCX Holdings will govern the activities of PCX Holdings.

a. Board of Directors

The Board of Directors of PCX Holdings shall consist of not less than seven (7) nor more than twelve (12) members, with the Board of Directors currently contemplated initially to consist of nine (9) members, including the Chief Executive Officer ("CEO") of PCX Holdings and at least five (5) persons who shall not have any material business relationship with PCX Holdings or its affiliates, other than as an OTP Holder on the reorganized PCX. The authorized number of Directors shall be as determined from time to time upon the majority approval of the full Board of Directors. The CEO of PCX Holdings may be designated Chairman of the Board.

The current PCX Nominating Committee has consulted with the CEO of the current PCX

¹⁰ This right is subject to Trading Permit Holders' right to nominate their candidates.

and proposed a slate of Directors for the initial Board. This slate was part of the demutualization package sent to the members for a vote and will be put in place once the demutualization becomes effective. The PCX Holdings Nominating Committee will nominate subsequent Directors to the Board of Directors. The Nominating Committee shall nominate Directors for election at the annual meeting of stockholders. Such nominations shall comply with the Bylaws of PCX Holdings. The Chairman of the Board of Directors of PCX Holdings shall appoint the members of the PCX Holdings Nominating Committee.

The Board of Directors of PCX Holdings shall appoint the Chairman of the Board by majority vote. The Board of Directors shall be divided into three classes and serve in staggered terms of three years, as set forth in the Certificate of Incorporation. Each Director shall hold office until the expiration of the Director's term. If, however, there remains a vacancy on the Board of Directors (for example, the Director is not re-elected and the Director's successor is not elected or qualified), the Director shall continue to serve until his or her successor is elected and qualified or until his or her earlier death, resignation or removal. A Director may serve for any number of terms, consecutive or otherwise. Directors need not be stockholders of PCX Holdings.

b. Committees of PCX Holdings Board of Directors

PCX Holdings shall have a Board Audit Committee, Compensation Committee, and Nominating Committee. The Board of Directors of PCX Holdings may, by resolution passed by a majority of the Directors in office, establish one or more additional committees ("PCX Holdings Board Committees"). Any such PCX Holdings Board Committee, to the extent provided in the resolution of the Board, shall have and may exercise all the power and authority of the Board of Directors for direction and supervision of the management of the business and

affairs of PCX Holdings. No such PCX Holdings Board Committee, however, shall have power or authority to amend the Certificate of Incorporation or the Bylaws, adopt an agreement of merger or consolidation, recommend to the stockholders the sale, lease, or exchange of all or substantially all of PCX Holdings' property and assets, recommend to the stockholders a dissolution of PCX Holdings or a revocation of a dissolution, elect a Director or elect or remove an officer, and, unless the resolution expressly so provides, no such committee shall have the power or authority to declare a dividend or to authorize the issuance of stock.

c. Management

The officers of PCX Holdings shall include the Chairman of the Board of Directors, CEO, Secretary, and such other officers as are desirable for the conduct of the business of the corporation in the opinion of the CEO. The Chairman of the Board of Directors shall appoint officers of PCX Holdings, other than the Chairman of the Board of Directors and the CEO. The same person may hold any two or more offices. The officers of PCX Holdings will manage the business and affairs of PCX Holdings, subject to the oversight of the Board of Directors.

d. Shareholder Restrictions

The Certificate of Incorporation and Bylaws of PCX Holdings place certain restrictions on the ability to transfer and own the stock of PCX Holdings. For a period of 30 days following the effective date of the demutualization, PCX Holdings stockholders will not be permitted to sell their shares unless the Board of Directors of PCX Holdings waives the transfer restriction. Regardless of whether such transfer restriction is waived, PCX Holdings stockholders will remain subject to the ownership and voting concentration limits and minimum lot transfer provisions described below.

No person (“Person”), either alone or together with its related persons (“Related Persons”),¹¹ may own shares constituting more than forty percent (40%) of the outstanding shares of capital stock of PCX Holdings.¹² This provision can be waived by an amendment to the Bylaws of PCX Holdings approved by the Board, subject to the Board having determined that such Person is not subject to any applicable "statutory disqualification" (within the meaning of Section 3(a)(39) of the Act),¹³ and the amendment being approved by the Commission. No trading permit holder of the reorganized PCX or equities trading permit holder of PCX Equities, either alone or together with its Related Persons, may own shares constituting more than twenty percent (20%) of the outstanding shares of common stock of PCX Holdings.¹⁴ Any Person, either alone or together with its Related Persons, that at any time owns of record or beneficially, whether directly or indirectly, five percent (5%) or more of then outstanding shares of capital stock, who has the right to vote in the election of the Board of Directors of PCX Holdings, shall, immediately upon so owning five percent (5%) or more of the then outstanding shares of such stock, give the Board of Directors of PCX Holdings written notice of such ownership.¹⁵

No Person, either alone or together with its Related Persons, may vote, possess the right to vote or cause the voting of shares representing more than twenty percent (20%) of the issued and outstanding capital stock of PCX Holdings.¹⁶ This provision can be waived by an amendment to the Bylaws of PCX Holdings approved by the Board of Directors, subject to the

¹¹ See PCX Holdings Certificate of Incorporation, Article 9, Section 1(b)(iv) for definitions of the terms “Person” and “Related Persons.”

¹² PCX Holdings Certificate of Incorporation, Article 9, Section 1(b)(i).

¹³ 15 U.S.C. 78c(a)(39).

¹⁴ PCX Holdings Certificate of Incorporation, Article 9, Section 1(b)(ii).

¹⁵ PCX Holdings Certificate of Incorporation, Article 9, Section 1(b)(iii).

¹⁶ PCX Holdings Certificate of Incorporation, Article 9, Section 1(c).

Board of Directors having determined that such person is not subject to any applicable "statutory disqualification" (within the meaning of Section 3(a)(39) of the Act), and the amendment being approved by the Commission.

If any stockholder purports to vote, or sell, transfer, assign or pledge any shares to any person other than PCX Holdings in a transaction that would violate the transfer restrictions and voting and ownership concentration limits, then PCX Holdings shall record on its books the transfer of only that number of shares that would not violate these provisions and shall treat the remaining shares as owned by the purported transferor for all purposes, including, without limitation, voting, payment of dividends, and distributions.¹⁷ In addition, if any stockholder purports to vote, or sell, transfer, assign or pledge any shares to any person in a transaction that would violate the transfer restrictions and voting and ownership concentration limits, then PCX Holdings shall have the right to redeem such shares at a price equal to the par value thereof, upon the approval of the PCX Holdings Board of Directors.¹⁸

Unless otherwise approved by the CEO of PCX Holdings, transfers of shares of the capital stock of PCX Holdings may be made only in minimum lots of 1,000 shares for a period of one year after the demutualization and thereafter in minimum lots of 100 shares.¹⁹ Holders of PCX Holdings capital stock will have no redemption or preemptive rights. However, PCX Holdings may redeem shares of its capital stock acquired in violation of the transfer restrictions and ownership and voting concentration limits contained in its Certificate of Incorporation for a price per share equal to the par value thereof, upon the approval of the PCX Holdings Board of Directors..

¹⁷ PCX Holdings Certificate of Incorporation, Article 9, Section 2.

¹⁸ PCX Holdings Certificate of Incorporation, Article 9, Section 3.

¹⁹ PCX Holdings Bylaws, Article 6, Section 6.07.

In the case of transactions relating to PCX Holdings, a merger, consolidation, sale of all or substantially all of the assets, or dissolution must be approved by an affirmative vote of at least a majority of the outstanding shares.²⁰

A merger, asset sale, or other business combination with a person who, together with affiliates and associates, owns or controls fifteen percent (15%) or more of the voting stock of PCX Holdings ("interested stockholder") during the three-year period after the date that the person became an interested stockholder will require approval by at least two-thirds of the outstanding voting stock of PCX Holdings, which is not owned by the interested stockholder, and the prior approval of the Board of Directors of PCX Holdings.²¹

e. Self-Regulatory Functions and Oversight

There are various provisions in the Bylaws of PCX Holding that are designed to protect the independence of the self-regulatory function of the reorganized Exchange or to clarify the Commission's oversight responsibilities.

Under the Bylaws of PCX Holdings, PCX Holdings must give due regard to the preservation of the independence of the self-regulatory function of the reorganized PCX and to its obligations to investors and the general public and shall not take any actions which would interfere with the effectuation of any decisions by the Board of Directors of the reorganized PCX relating to its regulatory functions or the structure of the market which it regulates or which would interfere with the ability of the reorganized PCX to carry out its responsibilities under the

²⁰ PCX Holdings Bylaws, Article 2, Section 2.06(b). PCX represents, however, that under Delaware law this provision would not be applicable if such interested stockholder owned at least 85% of the voting stock of PCX Holdings outstanding at the time the transaction commences, excluding certain shares. Telephone conversation between Mai Shiver, Acting Director and Senior Counsel, PCX, and Frank N. Genco, Attorney, Division, Commission, on March 3, 2004.

²¹ PCX Holdings Bylaws, Article 2, Section 2.06(b).

Act.²² Moreover, all books and records and the information contained therein of the reorganized PCX reflecting confidential information pertaining to the self-regulatory function of the reorganized PCX, which shall come into the possession of PCX Holdings, shall be retained in confidence by PCX Holdings and its Board of Directors, officers, employees, and agents, and shall not be used for any non-regulatory purposes.²³

PCX Holdings Bylaws provide that, to the extent that they are related to the activities of the reorganized Exchange, the books, records, premises, officers, directors, agents and employees of PCX Holdings are deemed to be the books, records, premises, officers, directors, agents, and employees of the reorganized Exchange for purposes of and subject to oversight pursuant to the Act.²⁴

In addition, pursuant to PCX Holdings Bylaws, PCX Holdings and its officers, directors, employees and agents, by virtue of their acceptance of such position, are deemed to irrevocably submit to the exclusive jurisdiction of the U.S. federal courts, the Commission, and the Exchange for the purposes of any suit, action or proceedings pursuant to the U.S. federal securities laws and the rules and regulations thereunder, arising out of, or relating to, the activities of the reorganized Exchange.²⁵ Further, PCX Holdings and its 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 Commission, that the suit, action or proceeding is an inconvenient forum or that the venue of the suit, action or

²² PCX Holdings Bylaws, Article 3, Section 3.15.

²³ Id.

²⁴ PCX Holdings Bylaws, Article 7, Section 7.03.

²⁵ PCX Holdings Bylaws, Article 7, Section 7.04.

proceeding is improper, or that the subject matter thereof may not be enforce in or by such courts or agency.²⁶ Moreover, PCX Holdings Bylaws provide that the officers, directors, employees and agents of PCX Holdings, by virtue of their acceptance of such position, are deemed to agree to cooperate with the Commission and the reorganized Exchange in respect of the Commission's oversight responsibilities with respect to the Exchange and the self-regulatory functions and responsibilities of the Exchange.²⁷

Finally, PCX Holdings Certificate of Incorporation and Bylaws provide that, before any amendment to or repeal of a provision of the Certificate of Incorporation or Bylaws, respectively, shall be effective, it must be submitted to the Board of Directors of the reorganized Exchange and if that Board determines that the amendment or repeal of such provision must be filed with the Commission before it may be effective, the amendment or repeal of such provision shall not be effective until it is filed with the Commission.²⁸

2. Reorganized PCX

The reorganized PCX will be a wholly-owned subsidiary of PCX Holdings that will continue to be a non-stock membership corporation with its own Board of Directors. PCX Holdings will be the sole member of, and, as such, will have one hundred percent (100%) voting

²⁶ Id.

²⁷ PCX Holdings Bylaws, Article 7, Section 7.05. The Commission notes that the staff of the Exchange has indicated that it would present to the Board of Directors of PCX Holdings for its approval a proposed new Bylaws provision stating that PCX Holdings would take such action as is necessary to insure that its officers, directors and employees consent to the applicability of Sections 7.03 and 7.04 of the Bylaws with respect to Exchange-related activities. Letter from Kathryn Beck, Senior Vice President, General Counsel, Corporate Secretary and Chief Regulatory Officer, PCX, to Elizabeth King, Associate Director, Division, Commission, dated May 13, 2004.

²⁸ PCX Holdings Certificate of Incorporation, Article 14, and PCX Holdings Bylaws, Article 7, Section 7.06.

control over the reorganized PCX (“Holding Member”).²⁹ Only the Holding Member will have any right to take part in the ownership of the Exchange and will be the Exchange’s sole Corporate Member.³⁰ The reorganized PCX will retain the self-regulatory organization function with respect to the members of the current Exchange. PCX Equities will continue to be a wholly-owned subsidiary of the reorganized PCX. OTP Holders (as well as Exchange Trading Permit (“ETP”) Holders of PCX Equities) will have the right to representation on the Board of Directors of the reorganized PCX. The Board of Directors of the reorganized PCX also will have the right to amend the Bylaws of the reorganized PCX.

a. Governing Documents and PCX Rules

The proposed PCX Certificate of Incorporation, PCX Bylaws, and PCX Rules will govern the activities of the reorganized PCX. Proposed PCX Rules 1 through 3 relate to qualifications for OTPs and corporate governance.³¹ The reorganized PCX’s Rules and Bylaws will reflect the status of the reorganized Exchange as a wholly-owned subsidiary of PCX Holdings, under management of the reorganized PCX Board of Directors and its designated officers, and with self-regulatory responsibilities pursuant to PCX’s registration under Section 6 of the Act.³²

b. Board of Directors

The Board of Directors shall consist of not less than eight (8) or more than twelve (12)

²⁹ The term “Holding Member” is defined in PCX Bylaws, Article II, Section 2.01. Pursuant to this provision of the PCX Bylaws, the reorganized PCX is a non-stock corporation consisting of a sole member, which is PCX Holdings (also referred to as the Holding Member).

³⁰ Under the reorganized PCX’s Certificate of Incorporation, Corporate Member refers to any member of the Exchange within the meaning of Section 102(4) of the General Corporation Law of the State of Delaware.

³¹ See Section II.C. infra for a description of the Rules of the reorganized PCX.

³² 15 U.S.C. 78f.

Directors, with the Board of Directors to consist initially of ten (10) Directors, including the CEO of PCX Holdings. The authorized number of Directors shall be as determined from time to time by the Board of Directors. At least fifty percent (50%) of the Directors will be persons from the public and will not be, or be affiliated with, a broker-dealer in securities or employed by, or involved in any material business relationship with, the reorganized PCX or its affiliates ("Public Directors").³³ At least twenty percent (20%) of the Directors shall consist of individuals nominated by the trading permit holders, with at least one Director nominated by the ETP Holders³⁴ of PCX Equities, Inc. and with at least one Director nominated by the OTP Holders of the reorganized PCX (collectively the "Permit Holder Directors"). The exact number of Public Directors and Permit Holder Directors shall be determined from time to time by the Board of Directors, subject to the percentage restrictions described in proposed Article III, Section 3.02(a) of the reorganized PCX's Bylaws. The term of office of a Director shall not be affected by any decrease in the authorized number of Directors.

The initial Directors of the reorganized Exchange shall consist of individuals nominated by the Nominating Committee of the current PCX in consultation with the CEO and shall be approved by the Board of Governors of the current PCX. At the first annual meeting and at each subsequent annual meeting of the Holding Member, except as otherwise provided by the reorganized PCX's Bylaws, the Holding Member shall elect Directors to serve until the next annual meeting or until their successors are elected and qualified. The Board of Directors shall appoint the Chairman of the Board by majority vote.

Each Director shall hold office for a term that expires at the annual meeting of the Holding Member following his or her election, provided that if he or she is not re-elected and his

³³ PCX Bylaws, Article III, Section 2(a).

³⁴ See PCXE Rule 1.1(n) for a definition of "ETP Holder".

or her successor is not elected and qualified at the meeting and there remains a vacancy on the Board of Directors, he or she shall continue to serve until his or her successor is elected and qualified or until his or her earlier death, resignation, or removal. A Director may serve for any number of terms, consecutive or otherwise.

c. Committees of the Board of Directors

The reorganized PCX Board Committees shall consist of the following: (1) a Board Appeals Committee; (2) a Regulatory Oversight Committee; (3) an Audit Committee; and (4) a Compensation Committee. The Board of Directors may, by resolution passed by a majority of the Directors in office, establish one or more additional committees ("Board Committees"), each committee to consist of one or more Directors. Each Board Committee shall be composed of at least fifty percent (50%) Public Directors. Each Board Committee, to the extent provided in the resolution of the Board creating the committee, shall have and may exercise all of the power and authority of the Board of Directors for direction and supervision of the management of the business and affairs of the reorganized Exchange, and may authorize the seal of the Exchange to be affixed to all papers that may require it. No Board Committee, however, shall have power or authority to amend the Certification of Incorporation or the Bylaws, adopt an agreement of merger or consolidation, recommend to the Holding Member the sale, lease or exchange of all or substantially all of the Exchange's property and assets, recommend to the Holding Member a dissolution of the Exchange or a revocation of a dissolution, elect a Director, or elect or remove an officer; and unless the resolution expressly so provides, no Board Committee shall have the power or authority to declare a dividend or to authorize the issuance of membership interests.

d. Nominating Committee

After the formation of the initial Board of Directors, the Nominating Committee of the Board of Directors of PCX Holdings will nominate Directors for election to the Board of Directors of the reorganized PCX at the annual meeting of the Holding Member. Such nominations shall comply with the Bylaws and Rules of the reorganized PCX. The reorganized PCX Nominating Committee will nominate the OTP Holder nominee(s) to the Board of Directors. The selection process for the OTP Holder nominee(s) differs from the selection process for the ETP Holder nominee.³⁵ Specifically, after the nomination by petition period has closed, the Board of Directors of PCX Holdings shall have ten (10) business days to object to the nomination of any or all of the OTP Holder nominee(s). The Board of Directors of PCX Holdings may, in its sole discretion, object to the nomination of any or all of the OTP Holder nominee(s) if the nominee(s) have been disciplined by any securities self-regulatory organization or the nominee would be subject to statutory disqualification within the meaning of Section 3(a)(39) of the Act. Any nominee who is objected to by the Board of Directors of PCX Holdings is not eligible to be considered as a nominee or petition candidate until the expiration of the current term of the Board of Directors. If the Board of Directors of PCX Holdings objects to all of the proposed nominees, the Nominating Committee shall publish the name of an eligible alternative nominee by the later of ten (10) business days after the Board of Directors of PCX Holdings notifies the Secretary of the reorganized Exchange of their objection to the proposed nominee(s) or sixty-five days prior to the expiration of the term of the Directors. If the Board of Directors of PCX Holdings objects to all of the original nominees, the above-noted process shall continue with all of the same deadlines until the Nominating Committee nominates a nominee that is not objected to by the Board of Directors of PCX Holdings.

³⁵ PCX represents that the ETP Nominee will be appointed to the reorganized PCX Board of Directors as required by the PCX/PCXE Shareholder Voting Agreement.

According to PCX, the purposes for allowing the Board of Directors of PCX Holdings to object to an OTP Holder nominee(s) are: (1) to accord PCX Holdings, as sole member of the reorganized PCX, the voting rights normally provided to a member of a membership organization; and (2) to provide the Board of Directors of PCX Holdings the ability to object to the nomination of particular individuals that, for various reasons, would be inappropriate as a director of a self-regulatory organization. PCX represents that, in both of the above circumstances, OTP Holders will still be afforded "fair" representation as required under the Act because, as a result of the process described above, a representative nominated by the OTP Holders will be selected.

e. Management

The Board of Directors shall elect such officers of the reorganized PCX, as it deems appropriate, which must include a Secretary, and which may include a President, a CEO, and, upon the recommendation of the CEO, any other officers as are desirable for the conduct of the business of the corporation. Any two or more offices may be held by the same person. The officers of the reorganized PCX will manage the business and affairs of the Exchange, subject to the oversight of the Board of Directors, and, in some cases, the approval of PCX Holdings as the sole member.³⁶

f. Disciplinary Process

The reorganized PCX will retain the self-regulatory organization function for the options business of the PCX, as well as for its equities business subsidiary, PCX Equities. The proposed

³⁶ According to the Exchange, under Delaware law events such as the sale of all or substantially all assets, a merger, or liquidation of the reorganized PCX may require the approval of the Board of Directors of PCX Holdings. Telephone conversation between Mai Shiver, Acting Director and Senior Counsel, and Steve Matlin, Senior Counsel, PCX, and Nancy J. Sanow, Assistant Director, and Frank N. Genco, Attorney, Division, Commission, on March 17, 2004 ("Telephone Conversation on March 17, 2004").

demutualization will not affect PCXE's current disciplinary process. The reorganized PCX's disciplinary process will be the same as the existing PCX disciplinary process and will be governed by an Ethics and Business Conduct Committee ("EBCC"). The reorganized PCX Board of Directors or a designee of the reorganized PCX will appoint the EBCC. The EBCC shall be made up primarily of OTP Holders and Allied Persons³⁷ of an OTP Firm. At least one member of the public shall serve on the EBCC.³⁸

The Chief Regulatory Officer of the reorganized PCX or his or her staff will authorize the initiation of disciplinary actions and proceedings. As is presently the case, the EBCC will conduct hearings, render decisions, and impose sanctions. Decisions of the EBCC may be appealed for review to a Board Appeals Committee, which will be appointed by the reorganized PCX's Board of Directors and will include public members, the OTP representative(s), and the ETP representative(s) of the Board of Directors. Decisions of the Board Appeals Committee shall be subject to the review of the reorganized PCX's Board of Directors.

g. Other Committees

The proposed Bylaws and Rules of the reorganized PCX envision three Options committees - the Nominating Committee, the Ethics and Business Conduct Committee, and the OTP Advisory Committee.³⁹ However, the Board of Directors may, by resolution passed by a majority of Directors in the office, establish other Options committees, if it deems it appropriate.

³⁷ "Allied Person" is defined in PCX Rule 1.1(b) as an individual, who is: (1) an employee of an OTP Firm who controls such firm; (2) an employee of an OTP Firm corporation who is a director or principal executive officer of such corporation; (3) an employee of an OTP Firm limited liability company who is a manager or a principal executive officer of such limited liability company; or (4) a general partner in an OTP Firm partnership.

³⁸ PCX represents that committees involved in the disciplinary process will remain unaffected by the demutualization.

³⁹ The OTP Advisory Committee shall act in an advisory capacity regarding rule changes related to disciplinary matters and trading rules. See PCX Rule 3.2(b)(3).

Except for the Nominating Committee, the Board of Directors of the reorganized PCX will appoint the members of all Options Committees for terms of one year. The CEO of the reorganized PCX will appoint the Chair and Vice Chair of each Options Committee. OTP Holders and public representatives may be appointed to serve on Options Committees.

h. Options Listings and Delistings

The management of the reorganized PCX will make all decisions with respect to listing and delisting options and related products in accordance with rules and standards comparable to those set forth in the current PCX Rules and used by the Option Listing Committee of the current PCX.

i. Regulation/Disciplinary Process

Following the demutualization, the reorganized PCX will operate as a national securities exchange registered under Section 6 of the Act.⁴⁰ For purposes of the Act, OTP Holders and OTP Firms will be deemed "members" of the reorganized PCX.

As a registered national securities exchange and self-regulatory organization, the reorganized PCX will continue to carry out its statutory responsibilities to enforce compliance by OTP Holders and OTP Firms (including ETP Holders of its equities business subsidiary, PCX Equities) with the provisions of the federal securities laws and the applicable Rules of the reorganized PCX and of PCX Equities. As the registered self-regulatory organization, the reorganized PCX will continue to have ultimate responsibility for the administration and enforcement of rules governing the options and equities business operations.

⁴⁰ 15 U.S.C. 78f.

The reorganized PCX will continue to be required to approve any changes to the Rules and governing documents of PCX Equities and to file any such changes with the Commission pursuant to Section 19(b) of the Act⁴¹ and Rule 19b-4 thereunder.⁴²

j. National Market System Plans

PCX currently is a participant in various national market system ("NMS") plans, including the Consolidated Tape Association ("CTA") Plan, the Consolidated Quotation System ("CQS") Plan, the Intermarket Trading System ("ITS") Plan, the Options Price Reporting Authority ("OPRA"), the Options Intermarket Linkage ("Linkage") Plan, and the Reporting Plan for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis ("Nasdaq UTP") Plan.⁴³ These plans are joint industry plans entered into by self-regulatory organizations for the purpose of addressing last sale reporting, quotation reporting, intermarket equities trading, options price reporting, and intermarket options trading, respectively.

Following the completion of the demutualization, the reorganized PCX, in its continuing role as the self-regulatory organization, will continue to serve as the voting member of these NMS plans. For those plans that relate to equity trading (i.e., the CTA Plan, the CQS Plan, the ITS Plan, and the Nasdaq UTP Plan) a PCX Equities representative will continue to serve as the reorganized PCX's representative with respect to dealing with these plans.⁴⁴ Similarly, the reorganized PCX expects that a representative of the reorganized PCX will serve as its

⁴¹ 15 U.S.C. 78s(b).

⁴² 17 CFR 240.19b-4.

⁴³ Telephone conversation between Mai Shiver, Acting Director and Senior Counsel, PCX, and Frank N. Genco, Attorney, Division, Commission, on March 3, 2004, confirming that PCX is a participant in the Nasdaq UTP Plan.

⁴⁴ Id.

representative with respect to those NMS plans that relate to options trading (i.e., OPRA and Linkage).

3. PCX Equities

PCX Equities will be a wholly-owned stock subsidiary of the reorganized PCX. The proposed demutualization will not affect PCXE's operations, governance structure, or rules.

a. Agreements between the Current PCX and PCX Equities

Currently, the PCX options operations and equities operations share certain infrastructure and personnel. After the completion of the demutualization, these shared assets will continue to be owned by the reorganized PCX and the shared personnel will continue to be employed by the reorganized PCX. In each case, however, PCX Equities will have access to those resources through inter-company agreements with the reorganized PCX. In particular, the reorganized PCX will continue to provide PCX Equities with certain management and support services and staff. The services provided are for administration, membership, technology, finance, accounting, human resources, and legal services. PCX represents that the agreement between the reorganized PCX and PCX Equities will allocate charges for these services and staff between the reorganized PCX and PCX Equities.

B. Option Trading Permits

1. Privileges Conferred by OTPs

The reorganized PCX will be authorized to issue OTPs that will entitle holders of the permits to trade options on the options trading facilities of the reorganized PCX, including the

options trading floor, POETS,⁴⁵ PCX Plus,⁴⁶ or any other systems approved by the Board of Directors, as a Market Maker, Floor Broker or order-flow firm. OTP Holders may engage in trading of options in the same manner as currently practiced by PCX Members who trade on the options trading facility.⁴⁷

An OTP does not grant its holder any right to trade securities on PCX Equities. Any OTP Holder that wishes to trade securities on PCX Equities must be approved for, and obtain an ETP pursuant to, the PCXE's application procedures.

OTP Holders will have limited voting rights and may nominate, through the Nominating Committee or by petition, at least one member to the reorganized PCX Board of Directors.

OTP Holders will hold six of the seven positions on the Nominating Committee. Subsequent nominations to the Nominating Committee will be made by the sitting Nominating Committee. The seventh position on the Nominating Committee will be a person from the public

⁴⁵ Currently, PCX operates an electronic order routing and execution system called Pacific Options Exchange Trading System ("POETS"), and several other peripheral systems including the Pacific Options Processing System ("POPS") and the Floor Broker Hand Held trading system, in conjunction with traditional open outcry trading with Floor Brokers and competing Market Makers.

⁴⁶ PCX Plus is the Exchange's electronic order delivery, execution, and reporting system for designated option issues through which orders and quotes with size of members are consolidated for execution and/or display. This trading system includes the electronic communications network that enables registered Market Makers to enter orders/quotes with size and execute transactions from remote locations or the trading floor. See Securities Act Release No. 47838 (May 13, 2003), 68 FR 27129 (May 19, 2003) (order approving File No. SR-PCX-2002-36).

⁴⁷ PCX intends to simplify its membership rules by eliminating Automated System Access Privileges ("ASAPs"). ASAPs refer to a permit issued by the Exchange for effecting option transactions principally over an electronic or automated system such as POETS. Under current PCX Rule 1.14, an ASAP member that wishes to obtain electronic access to the Options Floor must be a registered broker-dealer and approved by the Membership Committee. To date, the Exchange has issued no ASAPs. Because the reorganized PCX proposes to issue OTPs, there will no longer be a need for two separate membership categories. Therefore, PCX represents that the rules related to ASAPs will be rescinded.

selected by the CEO of the reorganized PCX.

OTP Holders will not have any distribution or other ownership rights in the reorganized PCX or PCX Holdings by virtue of their status as OTP Holders.

2. Number of OTPs

There will be no limit on the number of OTPs issued by the reorganized PCX.

3. Qualification for OTPs

The reorganized PCX will commence issuing OTPs once the demutualization is completed. Persons or entities that are registered broker-dealers and are not existing PCX members may be granted trading privileges on the reorganized PCX through an application process. OTP qualifications will be substantially the same as the current requirements for PCX membership.

The application process for applicants who are not current PCX members will be the same as is now required by PCX. The decision to grant or deny an application for trading privileges will be made by officers of the reorganized PCX (there will be no Membership Committee) and the denial of an application will be appealable to the reorganized PCX Board Appeals Committee.

4. Non-transferability of OTPs

OTPs will not be transferable by sale or lease, but they may be transferred by a firm holding an OTP between individuals within the same firm in accordance with the Rules of the reorganized PCX.

5. Cost of OTPs

Pursuant to the requirements of Section 19 of the Act,⁴⁸ PCX intends to set forth in a

⁴⁸ 15 U.S.C. 78s.

separate rule filing the fees for an OTP that will be assessed.

C. Rules of the Reorganized PCX

PCX represents that the majority of the Rules proposed to regulate the business conduct and practices of its OTP Holders, OTP Firms, and associated persons are closely patterned on PCX's existing Rules (with the exception of proposed PCX Rules 1 through 3). The reorganized Exchange's Rules contain changes to reflect the new structure whereby trading permits will be issued to persons or entities conducting business on the reorganized PCX. The discussion below indicates those Rules that reflect a significant departure from the current PCX Rules and, for those Rules that are closely patterned after existing PCX Rules, notes which current PCX Rules were used as a model and whether only minor conforming word changes and clean-up corrections were made.

1. Summary of Rules of the Reorganized PCX

Following the demutualization, the reorganized PCX will implement, subject to certain revisions, the applicable trading rules and standards of the current PCX as they relate to the current options trading business. Rules 1 through 3 of the reorganized PCX, which relate to definitions, qualifications for OTPs, and corporate governance, reflect significant departures from existing PCX Rules. The remaining rules are substantially similar to the current Rules, unless noted otherwise. The following section discusses the Rules of the reorganized Exchange that are contained in the proposed rule change, as amended, and that will be implemented by the reorganized Exchange in conjunction with the demutualization.

a. PCX Rule 1 – Definitions

PCX Rule 1 defines certain terms and references (e.g., OTP Holder) used throughout the Rules, and is intended to ensure uniformity in the use of such terms. In conjunction with the

demutualization and the issuance of the OTPs, the PCX has developed the following new terms and proposes to incorporate them into PCX Rule 1.

PCX Rule 1.1(h) – The term "Exchange" means the reorganized PCX, a Delaware corporation as described in the company's Certificate of Incorporation and Bylaws. The reorganized Exchange is a national securities exchange as that term is defined in Section 6 of the Act.⁴⁹

PCX Rule 1.1(n) – The term "Nominee" means an individual who is authorized by an OTP Firm, in accordance with PCX Rule 2.4, to conduct business on the Exchange's Trading Facilities (as defined below) and to represent such OTP Firm in all matters relating to the Exchange. As long as a Nominee remains effective, the Nominee will have status as a "member" of the Pacific Exchange, as that term is defined in Section 3 of the Act.⁵⁰ A Nominee must agree to be bound by the Bylaws and Rules of the Exchange, and by all applicable rules and regulations of the Commission.

PCX Rule 1.1(p) – The term "OTP" refers to an Options Trading Permit issued by the Exchange for effecting approved securities transactions on the Exchange's Trading Facilities. An OTP may be issued to a sole proprietor, partnership, corporation, limited liability company, or other organization which is a registered broker or dealer pursuant to Section 15 of the Act,⁵¹ and which has been approved by the Exchange.

PCX Rule 1.1(q) – The term "OTP Holder" refers to a natural person, in good standing, who has been issued an OTP, or has been named as a Nominee. An OTP Holder must be a

⁴⁹ 15 U.S.C. 78f.

⁵⁰ 15 U.S.C. 78c.

⁵¹ 15 U.S.C. 78o.

registered broker or dealer pursuant to Section 15 of the Act,⁵² or a Nominee or an associated person of a registered broker or dealer that has been approved by the Exchange to conduct business on the Exchange's Trading Facilities. An OTP Holder shall agree to be bound by the Bylaws and Rules of the Exchange, and by all applicable rules and regulations of the Commission. An OTP Holder shall not have ownership or distribution rights in the Exchange. An OTP Holder will have limited voting rights to nominate an OTP Holder to the Exchange's Board of Directors pursuant to proposed PCX Rule 3.2(b)(2)(C). An OTP Holder will have status as a "member" of the Pacific Exchange, as that term is defined in Section 3 of the Act.⁵³

PCX Rule 1.1(r) – The term "OTP Firm" refers to a sole proprietorship, partnership, corporation, limited liability company, or other organization in good standing who holds an OTP or upon whom an individual OTP Holder has conferred trading privileges on the Exchange's Trading Facilities pursuant to and in compliance with these rules. An OTP Firm must be a registered broker or dealer pursuant to Section 15 of the Act.⁵⁴ An OTP Firm shall agree to be bound by the Certificate of Incorporation, Bylaws, and PCX Rules of the Exchange, and by all applicable rules and regulations of the Commission. An OTP Firm shall not have ownership or distribution rights in the Exchange. An OTP Firm will have limited voting rights to nominate an OTP Holder to the Exchange's Board of Directors pursuant to PCX Rule 3.2(b)(2)(C). An OTP Firm will have status as a "member" of the current PCX, as that term is defined in Section 3 of the Act.⁵⁵

⁵² 15 U.S.C. 78o.

⁵³ 15 U.S.C. 78c.

⁵⁴ 15 U.S.C. 78o.

⁵⁵ 15 U.S.C. 78c.

PCX Rule 1.1(y) – The terms "self-regulatory organization" and "SRO" has the same meaning as set forth in the provisions of the Act relating to national securities exchanges.

PCX Rule 1.1(aa) – The term "Trading Facilities" refers to the Exchange's facilities for the trading of options, office space provided by the Exchange to OTP Holders and OTP Firms in connection with their floor trading activities, and any and all electronic or automated order execution systems and reporting services provided by the Exchange to OTP Holders and OTP Firms.

b. PCX Rule 2 – Option Trading Permits

PCX Rule 2, which describes the application process, the qualification requirements and other requirements for holding an OTP, is similar to the requirements and procedures now described in PCX Rule 1 of the current Exchange and certain sections of the Constitution of the current Exchange. However, as described below, certain substantive changes have been made to reflect the characteristics of the new OTPs. These substantive changes include the following:

PCX Rule 2.2 - In accordance with PCX Rule 2.2, an OTP may be issued to an individual, partnership, corporation, limited liability company, or other organization that is a registered broker-dealer. As discussed under Section 1.1(p) of PCX Rule 1, an OTP will authorize its holder to trade options on any facility of the reorganized PCX, including the options trading floor, POETS, or PCX Plus, as a registered Market Maker, Floor Broker, or order flow firm. An OTP will not confer any rights to trade on the Archipelago Exchange, i.e., the equities trading facility of PCX Equities. Any OTP Holder that wishes to trade securities on the Archipelago Exchange must be approved for and obtain a PCXE ETP pursuant to PCXE's standard application procedures.

PCX Rule 2.3 – To be consistent with the approach taken with respect to seat ownership, under PCX Rule 2.3(b), all firms that directly own OTPs are required to designate a natural person to hold their OTPs (i.e., the OTP Holder). Accordingly, whenever an OTP confers the right to vote (e.g., election of the Nominating Committee, as discussed below), it is the OTP Holder, rather than the OTP Firm, who casts the vote. However, pursuant to PCX Rule 2.21(c) (as discussed below), the OTP Firm retains the right to replace the OTP Holder with another qualified Nominee employed by the OTP Firm at any time. Therefore, since the reorganized PCX will use revocable proxies to conduct its votes, OTP Firms will be able to effectively control the voting process with respect to the OTPs that they own in the same manner as PCX member firms control the voting process with respect to Nominees today.

PCX Rules 2.4, 2.5, and 2.6 – PCX Rules 2.4, 2.5, and 2.6 would alter PCX’s existing member approval process by authorizing the reorganized PCX management - in place of a Membership Committee - to approve or reject OTP applicants. As described in PCX Rule 2.4(g), in the event that the Exchange rejects an application, the applicant will have the opportunity to appeal the decision to the Exchange’s Board Appeals Committee pursuant to proposed PCX Rule 10. Minor changes in terminology have been made to conform to the demutualization.

PCX Rule 2.21 – As described in PCX Rule 2.21(a) and (b), unlike current PCX memberships, OTPs may not be purchased, sold, or leased. Therefore, the current Exchange’s Rules 1.21 and 1.24 and sections of Rules 1.22 and 1.23 relating to the purchase, sale, or lease of memberships have been deleted from the reorganized PCX Rules. Under PCX Rule 2.21(c) of the reorganized Exchange, the only permissible transfers of OTPs are intra-firm transfers involving Nominees employed by the same firm. A new Nominee, unless he or she is a

previously approved person or approved Allied Person ⁵⁶of the OTP Firm, shall provide all information required for the Exchange to conduct an investigation of the Nominee prior to his or her approval as a Nominee.

PCX Rule 2.22 – Pursuant to PCX Rule 2.22, an OTP will terminate upon the occurrence of the permit holder’s expulsion, suspension without reinstatement, death, declaration of incompetence, dissolution, winding up, or other cessation of business. An OTP Holder whose trading privileges are terminated must be current in all filings and payments of dues, fees, and charges. If the OTP Holder fails to be current as required, the Exchange retains jurisdiction over the permit holder until such time as the permit holder is current. In addition, an OTP that confers trading privileges on an OTP Firm will terminate when the named OTP Holder ceases to be an employee of the OTP Firm. In that event, the OTP Firm may nominate another employee as its Nominee OTP Holder. An OTP Firm upon which trading privileges are conferred shall continue to be responsible for all obligations, including, without limitation, dues, fees, and charges imposed by or due to the Exchange.

The Exchange represents that, other than the substantive changes discussed above and minor conforming word changes that reflect the demutualization, each section of PCX Rule 2 (except PCX Rule 2.21 and PCX Rule 2.22) is substantially the same as a relevant corresponding PCX Rule or Article of the Constitution.

c. PCX Rule 3 – Organization and Administration

PCX Rule 3 sets forth the organization and governance structure of the reorganized PCX. PCX Rules 3.1 through 3.3 regarding Options and Board Committees were drafted using PCX

⁵⁶ See note 37 supra for a definition of Allied Person.

and PCXE Rules of the current Exchange as a starting point.⁵⁷ Under the rules of the reorganized Exchange, the use of a "member" committee structure will be reduced substantially.

PCX Rule 3.1 – PCX Rule 3.1 states that the Board of Directors may establish: (1) one or more Board committees consisting of one or more Directors of the Exchange; and (2) one or more Options committees consisting of people other than Directors. As discussed in more detail below, although the reorganized PCX's Board may establish additional Options Committees under this rule, the Bylaws and Rules of the reorganized PCX currently envision solely a Nominating Committee, an Ethics and Business Conduct Committee, and an OTP Advisory Committee. Similarly, although the Board may establish additional Board Committees, the Rules currently envision only a Board Appeals Committee, a Regulatory Oversight Committee, an Audit Committee, and a Compensation Committee.

PCX Rule 3.2(a) – PCX Rule 3.2(a) establishes the substantive and procedural rules for an Options Committee conducting meetings and exercising its authority. In particular, PCX Rule 3.2(a), which is similar to rules and procedures of the current PCX and of PCXE, discusses quorums, voting, conference call meetings, vacancies, the removal and resignation of committee members, and eligibility for and appointment to Options Committees, interested persons and subcommittees.

Under this rule, OTP Holders and Allied Persons⁵⁸ of OTP Firms as well as public representatives may be appointed to serve on Options Committees. No more than one person affiliated with the same OTP Firm will be eligible for service on the same Options Committee. PCX Rule 3.2(a) vests authority in the Board of Directors or such other designee of the

⁵⁷ See Rules 11.1(a)-(b), 11.2(a)-(b), 11.3 – 11.5, 11.6(b); and 11.8(d) of the current Exchange; Articles II – IV of the current Exchange's Constitution; and PCXE Rule 3.

⁵⁸ See note 37 supra.

reorganized PCX to appoint the members of Options Committees (other than the Nominating Committee). The CEO or such other designee of the reorganized PCX will appoint the Chair and Vice Chair of each Options Committee (other than the Nominating Committee).

PCX Rule 3.2(b)(1) – PCX Rule 3.2(b)(1) describes the functions and authority of the Ethics and Business Conduct Committee ("EBCC"). The reorganized PCX's disciplinary process will be similar to the existing PCX disciplinary process and will be governed by the EBCC. Pursuant to the proposed rule, the EBCC would have the following functions and authority: (1) examine the business conduct and financial condition of OTP Holders, OTP Firms, and associated persons; (2) conduct hearings and render decisions in summary disciplinary actions and proceedings; (3) impose appropriate sanctions of expulsion, suspension, fine, censure, or any other fitting sanctions where the Committee finds that a violation within the disciplinary jurisdiction of the Exchange has been committed; and (4) require the production of detailed financial reports of an OTP Holder or OTP Firm and such other operational reports as it may deem relevant.

In addition, under this rule, the EBCC will have the authority to examine and subsequently suspend an OTP Firm or OTP Holder if the person or entity is in violation of PCX Rule 4. Any such suspension is subject to review by the Board Appeals Committee. Such review shall not operate as a stay of the suspension unless specifically allowed by the Board. A person or firm that experiences a reversal of the suspension imposed by the Committee shall be prohibited from instituting a lawsuit against the Exchange or the Committee members.

Finally, decisions of the EBCC or sanctions imposed by the regulatory staff relating to disciplinary proceedings may be appealed to the Board Appeals Committee in accordance with PCX Rule 10.

PCX Rule 3.2(b)(2) – PCX Rule 3.2(b)(2) describes the characteristics and function of the Nominating Committee. Specifically, the Nominating Committee shall have seven members consisting of six OTP Holders and one public representative. Members of the Nominating Committee will be nominated in accordance with the procedures set forth in proposed PCX Rule 3.2(b)(2). This Rule states that, prior to the expiration of its term, the Nominating Committee shall publish a slate of six eligible nominees for the committee. OTP Holders may submit a petition to the Exchange in writing to nominate additional eligible candidates to fill the OTP positions. Upon written petition of the lesser of thirty-five or ten percent (10%) of the OTP Holders in good standing, the additional candidates shall also be nominated by the Nominating Committee. The CEO shall appoint a person from the public to fill the public position on the Nominating Committee.

If there are more than six nominees to fill the OTP Holder positions on the Nominating Committee, the Nominating Committee shall submit the nominees to the OTP Holders for election. Each OTP Holder in good standing shall be permitted to vote for up to six nominees and the six nominees receiving the most votes shall fill the OTP positions. Tie votes shall be decided by the Board of Directors at its first meeting following the election. If there are only six nominees to fill the OTP Holder positions, those six nominees shall be deemed elected to the Nominating Committee.

This Nominating Committee will nominate at least one nominee for the reorganized PCX Board. Such nominee may be an OTP Holder or Allied Person of an OTP Firm. OTP Holders may submit a written petition to the Exchange to nominate additional eligible candidates to fill the OTP Holder position and, upon written petition of the lesser of thirty-five (35) or ten percent

(10%) of OTP Holders in good standing, the additional person(s) shall also be nominated by the Nominating Committee.

After the nomination by petition period has closed, the Board of Directors of PCX Holdings shall have ten (10) business days to object to the nomination of any or all of the OTP Holder nominee(s). The Board of Directors of PCX Holdings may in its sole discretion object to the nomination of any or all of the OTP Holder nominee(s) if the nominee(s) have been disciplined by any securities SRO or the nominee would be subject to statutory disqualification within the meaning of Section 3(a)(39) of the Act. Any nominee who is objected to by the Board of Directors of PCX Holdings is not eligible to be considered as a nominee or petition candidate until the expiration of the current term of the Board of Directors. If the Board of Directors of PCX Holdings objects to all of the proposed nominees, the Nominating Committee shall publish the name of an eligible alternative nominee by the later of ten (10) business days after the Board of Directors of PCX Holdings notifies the Secretary of the reorganized Exchange of their objection to the proposed nominee(s) or sixty-five (65) days prior to the expiration of the term of the Directors. If the Board of Directors of PCX Holdings objects to all of the original nominees, the above-noted process will continue with all of the same deadlines, until the Nominating Committee nominates a nominee that is not objected to by the Board of Directors of PCX Holdings.

If there are two or more OTP Holder nominees for the Board of Directors of the reorganized PCX, the Nominating Committee shall submit the contested nomination to the OTP Holders for selection. Each OTP Holder may select one nominee for the contested seat on the Board of Directors. With respect to the contested positions, the nominee for the Board of Directors selected by the OTP Holders, shall be submitted by the Nominating Committee to the

Board of Directors. Similarly, the Nominating Committee shall submit an uncontested nominee to the Board of Directors. Tie votes shall be decided by the Board of Directors at its first meeting following the election.

PCX Rule 3.2(b)(3) – OTP Advisory Committee will be responsible for advising the management of the reorganized PCX regarding rule changes relating to disciplinary matters and trading rules. The OTP Advisory Committee will be made up of OTP Holders. According to PCX, attempts shall be made to have diverse OTP Holder representation of different constituencies on the Committee.

PCX Rule 3.2(c) – Under this Rule, each Options Committee will have such other powers and duties as delegated to it by the Board of Directors. Each Options Committee is subject to the control, review, and supervision of the Board of Directors.

PCX Rule 3.3(a)(1) – PCX Rule 3.3(a)(1) describes the functions and authority of the Board Appeals Committee. The Board Appeals Committee will be composed of the OTP Director(s), the ETP Director(s), and all of the Public Directors of the reorganized PCX. Board Appeals Committee Panels ("Appeals Panels") will be composed of members of the Board Appeals Committee. An Appeals Panel will be composed of no less than three (3), but no more than five (5) individuals.⁵⁹ The Appeals Panel will conduct reviews of matters subject to the applicable provisions of proposed PCX Rule 3.2(b)(1)(C) or 10. Each Appeals Panel will contain at least one Public Director and at least one Director that is an OTP Holder or Allied Person of an OTP Firm. Subject to PCX Rule 10, decisions of the Board Appeals Committee will be subject to the review of the Board of Directors. The decision of the Board of Directors will constitute the final action of the Exchange, unless the Board remands the proceedings.

⁵⁹ The body conducting the review, either the Board Appeals Committee itself or the Appeals Panel, is also referred to in the PCX Rules as the Review Board.

PCX Rule 3.3(a)(2) – PCX Rule 3.3(a)(2) describes the functions and authority of the Regulatory Oversight Committee ("ROC"). The ROC shall ensure: (1) the independence of Exchange regulation; (2) that the Exchange provides adequate resources to properly fulfill its SRO regulatory obligations; and (3) that Exchange management fully supports the execution of the regulatory process. The ROC shall be composed of all of the Public Directors of the reorganized PCX.

PCX Rule 3.3(a)(3) – PCX Rule 3.3(a)(3) describes the functions and authority of the Audit Committee. The Audit Committee shall be made up of at least three (3) Directors of the reorganized PCX. All members of the Audit Committee shall be Public Directors and at least one member of the Audit Committee shall have accounting or related financial management expertise, as the reorganized PCX Board of Directors interprets such qualification in its business judgment. The Audit Committee shall conduct an annual review with the independent auditors to determine the scope of their examination and the cost thereof. The Audit Committee shall periodically review with the independent auditors and the internal auditor, the Exchange's internal controls and the adequacy of the internal audit program. The Audit Committee shall review the annual reports submitted both internally and externally, and take such action with respect thereto as it may deem appropriate. The Audit Committee shall also recommend independent public accountants as auditors of the Exchange and its subsidiaries to the reorganized PCX Board of Directors.

PCX Rule 3.3(a)(4) – PCX Rule 3.3(a)(4) describes the functions and authority of the Compensation Committee. The Compensation Committee shall be made up of at least three (3) Directors of the reorganized PCX Board of Directors. Only one (1) non-Public Director may serve on the committee. The Compensation Committee shall review and approve corporate goals

and objectives relevant to the CEO's Compensation, evaluate the CEO's performance in light of those goals and objectives, and set the CEO's compensation level based on this evaluation. The Compensation Committee also shall make recommendations to the Board of Directors of the reorganized PCX with respect to the design of incentive compensation and equity-based plans.

PCX Rule 3.6 – Subject to minor word changes, PCX Rule 3.6 regarding surveillance agreements is the same as PCX Rule 14.1 of the current Exchange.

PCX Rules 3.7 – 3.9 – Other than minor conforming word changes, PCX Rules 3.7 through 3.9 are the same as Article XIV, Section 1 of the current Exchange's Constitution. Under these Rules, the reorganized PCX Board may impose reasonable fees, assessments, charges, or fines to be paid by OTP Holders or OTP Firms. The Exchange represents that, prior to implementing the demutualization, it will file with the Commission a rule proposal to change its Schedule of Fees and Charges for services provided by the reorganized PCX.

d. PCX Rule 4 – Capital Requirements, Financial Reports, and Margins

PCX Rule 4, which sets forth the net capital, financial reporting, and margin requirements for OTP Holders and OTP Firms, has been adapted from PCX Rule 2 of the current Exchange. Only minor conforming changes in terminology and clean-up corrections have been made to the Rules of the current Exchange.

e. PCX Rule 5 – Listings

PCX Rule 5 is comprised of the General Provisions and Definitions, Underlying Securities, Stock Index Options, Flexible Exchange Options, Buy-Write Option Unitary Derivatives (BOUNDS), and Portfolio Depositary Receipts. This Rule has been adapted from Rules 3, 7, and 8 of the current PCX. Only minor conforming changes in terminology and clean-up corrections have been made to the Rules of the current Exchange.

f. PCX Rule 6 – Options Trading

Other than the substantive changes discussed below and minor conforming word changes that reflect the demutualization, PCX Rule 6 is unchanged from Rule 6 of the current Exchange, which governs options trading. There are two notable modifications to the Exchange’s options trading rules. First, the Exchange seeks to confer jurisdiction currently held by the Options Floor Trading Committee to the Exchange. Second, the Exchange proposes to confer jurisdiction currently held by Floor Officials to either Trading Officials or the Exchange.⁶⁰

g. PCX Rule 7 – General Trading PCX Rules

PCX Rule 7, which pertains to general trading rules that address matters such as trading hours and access to trading facilities has been adapted from Rule 4 of the current Exchange. Only minor conforming changes in terminology have been made to the provisions of Rule 4 of the current Exchange.

h. PCX Rule 9 – Conducting Business with the Public

PCX Rule 9, which governs how OTP Holders and OTP Firms must conduct business with the public, is patterned after Rule 9 of the current PCX. Except for minor changes in terminology and clean-up corrections, this Rule is substantially the same as Rule 9 of the current Exchange.

i. PCX Rule 10 – Disciplinary Proceedings, Other Hearings, and Appeals

PCX Rule 10 describes the disciplinary process for the reorganized PCX. The reorganized PCX’s disciplinary process will be similar to the current PCX’s disciplinary process

⁶⁰ Initially, Trading Officials will be acting as officials of the Exchange as opposed to members of the Options Floor Trading Committee. Over time, the Exchange expects that the PCX’s regulatory staff will be primarily responsible for the general supervision of the conduct and dealings of OTP Holders, OTP Firms, and Associated Persons on the options trading facility.

(including summary sanction procedures under the Minor Rule Plan) and will be governed by the EBCC. Therefore, aside from conforming word changes and the substantive changes discussed below, PCX Rule 10 will be closely modeled after Rule 10 of the current Exchange.

PCX Rules 10.8(a) – This rule defines and clarifies the procedures and timetables for the respondent to follow when requesting the review of a decision by the Conduct Panel appointed by the EBCC.⁶¹ The respondent may appeal to the Board at any time within fifteen (15) calendar days after the decision has been served.

PCX Rule 10.8(b) – This rule provides that the Board Appeals Committee may appoint an Appeals Panel to review the decision rendered by the Conduct Panel. The composition of the Appeals Panel will be determined by the Board Appeals Committee in accordance with proposed PCX Rule 3.3(a)(1)(A). Unless the Review Board shall decide to open the record for the introduction of new evidence or to hear argument, such review shall be based solely upon the record and the written exceptions filed by the parties. The standard of review shall be de novo.

PCX Rules 10.14(a)-(m) – Rules 11.7(a)-(m) of the current Exchange, which pertain to appeals for non-disciplinary matters, will be incorporated into PCX Rule 10.14. PCX Rule 10.14 provides the procedures for persons aggrieved by any of the following actions taken by the reorganized Exchange to apply for an opportunity to be heard and to have the action reviewed. These actions are: (1) denial of an OTP; (2) the barring of any person from becoming associated with an OTP Firm; (3) the suspension or cancellation of OTP trading privileges; (4) the prohibition or limitation with respect to access to services provided by the Exchange, or the access to services of any OTP Firm taken pursuant to the Bylaws, or Rules or procedures of the

⁶¹ The Exchange is proposing to make certain technical changes throughout the text of the PCX Rule 10 for clarification purposes, e.g., adding references to calendar days.

Exchange; (5) actions taken pursuant to PCX Rules 6.37 (Obligations of Market Makers), 6.82(e) or (f) (regarding allocation or reallocation of option issues), and 6.82(g) (regarding qualification or disqualification of an LMM); or (6) the denial of an applicant for registration as a Market Maker, Lead Market Maker, or Floor Broker (PCX Rules 6.33, 6.44 and 6.82(b)(1)). The provisions of this Rule shall not apply to reviews of disciplinary action, for which review is already provided within proposed PCX Rule 10, and actions in Arbitration.

j. PCX Rule 11 – Business Conduct

PCX Rule 11 consolidates various options-related rules that address business practices, ethical standards, and prohibited acts contained in Rules 2 and 4 and the Constitution of the current Exchange. Other than minor conforming word changes that reflect the demutualization, each section of PCX Rule 11 is substantially the same as the relevant corresponding rule or Article of the current PCX.

k. Rule 12 – Arbitration

PCX Rule 12, the arbitration rule, has been patterned closely after Rule 12 of the current Exchange. Only minor changes in terminology have been made to conform this rule to the circumstances of the demutualization.

l. PCX Rule 13 – Expulsion, Suspension, and Reinstatement

PCX Rule 13 clarifies, restates, and reorganizes rules and procedures of the current Exchange regarding certain suspensions, cancellations, bars, and prohibitions on access to the reorganized PCX's services and facilities. The following describes provisions of Rule 13 and how they differ from Rule 13 of the current Exchange, where applicable.

PCX Rules 13.1(a)-(b) – PCX Rules 13.1(a)-(b) incorporate a modified version of Article X, Sections 1(a) and (b) of the current Exchange's Constitution. This rule requires an OTP

Holder or OTP Firm to give prompt written notice to the Exchange if it is expelled or suspended from any SRO, encounters financial difficulty or operating inadequacies, fails to perform contracts or becomes insolvent, or if any associated person of such OTP Firm is similarly expelled or suspended by an SRO.

PCX Rules 13.2(a)-(b) – PCX has reorganized and simplified its rules relating to summary and non-summary disciplinary proceedings. Rule 13.2(a)-(b) has been adapted from the NASD Rule 9510 Series and Article X, Section 2 and Article XI, Section 3(c) of the current Exchange’s Constitution. Rule 13.2(a)-(b) is intended to eliminate any potential ambiguities in the procedures relating to summary and non-summary suspensions by expressly identifying the grounds for imposing such suspensions.

PCX Rule 13.2(c) – PCX Rule 13.2(c) provides that action taken pursuant to PCX Rule 13.2(a) also shall be subject to the applicable provisions of PCX Rule 10.14. Furthermore, under Commentary .01, the Exchange will be required to notify the Commission in the event that it determines to take summary action pursuant to PCX Rule 13.2.

PCX Rule 13.3 – PCX Rule 13.3 states that an OTP Holder, OTP Firm, or Associated Person⁶² thereof loses all rights and trading privileges when those privileges are suspended or canceled by the Exchange. However, such person or organization shall remain subject to the disciplinary power of the Exchange.

PCX Rule 13.4 – PCX Rule 13.4 states that an OTP Holder, OTP Firm, or Associated Person thereof whose trading privileges are suspended may be disciplined by the Exchange for any offense committed either before or after the announcement of the suspension.

PCX Rule 13.5 – Other than minor word changes, PCX Rule 13.5 is modeled closely

⁶² “Associated Person” is defined in PCX Rule 1.1(d).

after Article X, Section 3 of the current PCX's Constitution. PCX Rule 13.5 states that a person or organization whose trading privileges have been suspended must immediately afford every resource required by the Exchange for the investigation of its affairs.

PCX Rule 13.6 – Other than minor word changes, PCX Rule 13.6 is modeled closely after Article X, Section 4 of the current PCX's Constitution. PCX Rule 13.6 describes the grounds for canceling trading privileges.

PCX Rule 13.7 – Other than minor word changes, PCX Rule 13.7 is modeled closely after Article X, Section 5 of the current Exchange's Constitution. PCX Rule 13.7 describes the reinstatement process after trading privileges have been suspended.

PCX Rule 13.8 – PCX Rule 13.8 provides that if any OTP Holder, OTP Firm, or any Associated Person is suspended and fails or is unable to apply for reinstatement or fails to obtain reinstatement, trading privileges conferred by an OTP will terminate.

m. PCX Rule 14 – Liability of Directors and Exchange

PCX Rule 14 has been adapted from Rule 13 of the current Exchange. Only minor changes in terminology have been made to conform the rule to the proposed demutualization.

n. Option Floor Procedure Advices ("OFPA")

The proposed rule change also contains revisions to various options floor procedures and policies that have been adopted over time. These revised OFPA have been adapted from existing ones, which were previously approved by the Commission. These OFPA will apply to OTP Holders, OTP Firms, or Associated Persons thereof that conduct business on the options trading facilities. Minor conforming changes in terminology have been made to the existing floor procedures and policies. In addition, the Exchange proposes to delete OFPA B-4 (Market Maker Trading on PCX Equity Floors) and OFPA D-8a (Marking Orders to Reflect Split Transactions)

because, according to PCX, they are obsolete and no longer applicable to the current trading environment.

III. Summary of Comments

The Commission received one comment letter in response to the proposed rule change.⁶³ The Brown Letter requested that the Exchange undertake several actions prior to Commission approval of the demutualization proposal. First, the Brown Letter suggested that the Exchange hold another vote on the proposal. The commenter argued that the Exchange's \$750 monthly seat assessment has reduced the value of Exchange seats and allegedly was undertaken to force out a group of dissident seat holders. The commenter urged that the assessment be stopped. Second, the commenter stated that the current PCX Chairman would receive ten percent (10%) of the stock in the reorganized Exchange and the Compensation Committee will award him stock options with a strike price based on the value of \$20,000 per seat. The commenter urged that PCX be required to rewrite the option plan both as to the amount of shares and strike price. Finally, the Brown Letter suggested that a new vote be scheduled after the above-mentioned remedies are in place.

In responding to the Brown Letter, the Exchange noted that the allegation suggesting that its management levied the \$750 monthly per seat charge for reasons that were not legitimate to the Exchange's business purpose is baseless.⁶⁴ The Exchange pointed out that this monthly charge was increased to its current level in February 1999, which it noted was months before current top senior management was in place. The PCX also noted that it temporarily waived the

⁶³ See Brown Letter, note 4 *supra*. The Brown Letter included as an attachment a letter from this commenter to Phil DeFeo, Chairman, PCX, dated October 29, 2003, which also raised issues regarding the Exchange's demutualization proposal.

⁶⁴ Letter from Kathryn L. Beck, Senior Vice President, General Counsel, Corporate Secretary and Chief Regulatory Officer, PCX, to Jonathan G. Katz, Secretary, Commission, dated April 29, 2004.

assessment for over a year to reduce the cost to carry an unassigned membership as a means to lessen the impact of the closure of the PCX's equities business and the migration of those seats to the options business.

Regarding the Brown Letter's statement that the current Chairman of PCX would unfairly receive 10% of the stock in the reorganized Exchange, the Exchange asserted that the statement is incorrect. According to the Exchange, there is no guarantee the Chairman, or any other employee, would receive any stock in PCX Holdings. While the stock incentive plan does reserve certain shares for the CEO of the reorganized Exchange, the PCX noted that PCX Holdings' Compensation Committee will administer the stock incentive plan, that the Committee will have the sole and absolute discretion to determine the terms, conditions, restrictions, and limitations of any awards issued pursuant to the plan,⁶⁵ and that, therefore, there is no guarantee that any of the reserved shares would be awarded to the CEO. Finally, the Exchange pointed out that terms and conditions of the stock incentive plan were fully disclosed to Exchange members prior to their vote on the demutualization proposal.

IV. Amendment No. 1 to the Proposed Rule Change

In Amendment No. 1 to the proposed rule change, the Exchange proposed revisions to various aspects of its proposal. The proposed revisions in Amendment No. 1 would:

- add PCX Rule 2.4(h) to specify the required activation time period for approved applications for an OTP;
- amend the employee registration procedure in PCX Rule 2.23(a)-(c) to reflect a rule amendment previously approved by the Commission;
- clarify the Nominating Committee's role in PCX Rule 3.2(b)(2)(C)(ii) in that if the Board of Directors is made up of more than 10 individuals, the Public Directors, after consulting

⁶⁵ The PCX noted that the plan reserves 40,500 shares (50% of the eligible shares) for the CEO, which is far less than the 10% of the 1,000,000 authorized shares that the Brown Letter claimed would be awarded to the CEO.

with the CEO, will determine whether the additional permit holder representative is an OTP Holder or an Equity Trading Permit Holder of PCX Equities, Inc., and if the additional representative is an OTP Holder, then the Nominating Committee shall nominate additional nominees so that at least twenty percent (20%) of the Directors consist of individuals nominated by trading permit holders;

- amend the text of PCX Rule 5.3(f)(1)-(4) regarding the listings of options on the securities of restructured companies;
- amend the description of securities in PCX Rule 5.3(g)(2)(A)-(C) in order to allow for trading of options on fixed-income exchange traded funds;
- amend PCX Rule 5.6(d) to add a missing cross-reference to PCX Rule 5.6(c);
- amend the index options rules set forth in PCX Rules 5.10-5.29 in order to reflect a rule amendment previously approved by the Commission;
- amend PCX Rule 6.8, Commentary .04, to reflect a rule amendment previously approved by the Commission;
- amend PCX Rule 6.11(a) to reflect a rule amendment previously approved by the Commission;
- amend PCX Rule 6.23 to add a reference to Article VII, Section 4 of the Bylaws for claims made pursuant to this rule;
- amend Rule PCX Rule 6.37(f) to remove the reference to the term “OFTC” and replace it with “two Trading Officials;”
- amend PCX Rule 6.37(b)(1)(F) to reflect a rule amendment previously approved by the Commission;
- amend PCX Rule 6.37(f)(2) to reflect a rule amendment previously approved by the Commission;
- amend PCX Rule 6.62 to reflect a rule amendment previously approved by the Commission;
- amend PCX Rules 6.82, 6.87(b)(6)-(7), and 6.90 to replace references to the term “Option Allocation Committee” with “Exchange;”
- clarify in Rule 7.1, Commentary .02, the trading hours for options on exchange traded funds;
- amend PCX Rules 9.2 and 9.11 to replace references to “Member” with “OTP Holder;”

- amend PCX Rule 9.18(d) to replace the cross-reference to PCX Rule 9.1(b) with PCX Rule 9.1(c);
- amend PCX Rule 10.1(a) to include associated persons of an OTP Holder to the group of individuals that are subject to PCX jurisdiction for disciplinary matters;
- amend PCX Rule 10.5(a) to change the minimum number of required Conduct Panel members from one to three;
- amend PCX Rule 10.14(a)(5) to add a cross-reference to PCX Rule 6.82(e);
- delete PCX Rule 10.14(m);
- delete PCX Rule 10.15(d);
- amend PCX Rule 11.9 to expand the provisions of prohibited discretionary transactions to include transactions executed through ITS or any other Application of the System;
- amend PCX Rules 12.1(e)(3)&(4) to add Allied Persons of OTP Holders and OTP Firms to the list of individuals covered under the provisions for class action arbitration claims;
- amend PCX Rule 12.8, Commentary .01 to reinsert Los Angeles as an acceptable forum for arbitrations;
- amend PCX Rule 13.2(a)(1)(C) to delete a section and remove the Board's ability to suspend the trading privileges of an OTP Holder, OTP Firm, or any Associated Person of an OTP Firm who is found in violation of any of the prohibited acts as specified in Rule 11.2(a)-(f); and
- delete the former PCX Constitution and Certificate of Incorporation.

V. **Discussion**

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.⁶⁶ In particular, the Commission finds that the proposed rule change is

⁶⁶ 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).

consistent with Section 6(b)(1) of the Act,⁶⁷ which requires a national securities exchange to be so organized and have the capacity to carry out the purposes of the Act and to enforce compliance by its members and persons associated with its members with the provisions of the Act. The Commission also finds that the proposed rule change is consistent with Section 6(b)(3) of the Act,⁶⁸ which requires that the rules of a national securities exchange assure the fair representation of its members in the selection of its directors and administration of its affairs, and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer. Further, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,⁶⁹ 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. PCX Holdings as Sole Member

Following completion of the demutualization of PCX, PCX Holdings will be the sole member of the reorganized PCX, which is a non-stock membership corporation. Section 19(b) of the Act⁷⁰ and Rule 19b-4 thereunder⁷¹ require a self-regulatory organization (“SRO”) to file proposed rule changes with the Commission. Although PCX Holdings is not an SRO, certain

⁶⁷ 15 U.S.C. 78f(b)(1).

⁶⁸ 15 U.S.C. 78f(b)(3).

⁶⁹ 15 U.S.C. 78f(b)(5).

⁷⁰ 15 U.S.C. 78s.

⁷¹ 17 CFR 240.19b-4.

provisions of its Certificate of Incorporation and Bylaws may be rules of an exchange⁷² if they are the stated policies, practices, or interpretations, as defined in Rule 19b-4 of the Act,⁷³ of the reorganized PCX. Any proposed rule or any proposed rule change in, addition to, or deletion from the rules of an exchange must be filed pursuant to Section 19(b) of the Act and Rule 19b-4 thereunder.⁷⁴ Accordingly, PCX has filed the Certificate of Incorporation and Bylaws of PCX Holdings with the Commission.⁷⁵

B. Changes in Control of PCX

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

The reorganized PCX will continue to be a non-stock membership corporation. Its

⁷² 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).

⁷³ 17 CFR 240.19b-4. The term “stated policy, practice, or interpretation” includes any material aspect of the operation of an SRO.

⁷⁴ PCX Holdings Certificate of Incorporation and Bylaws provide that, before any amendment to or repeal of a provision of the Certificate of Incorporation or Bylaws, respectively, shall be effective, it must be submitted to the Board of Directors of the reorganized Exchange and if that Board determines that the amendment or repeal of such provision must be filed with the Commission before it may be effective, the amendment or repeal of such provision shall not be effective until it is filed with the Commission. PCX Holdings Certificate of Incorporation, Article 14, and PCX Holdings Bylaws, Article 7, Section 7.06.

⁷⁵ See PCX Holdings Certificate of Incorporation, Article 14, and PCX Holdings Bylaws, Article 7, Section 7.06.

Bylaws establish PCX Holdings as the sole member.⁷⁶ Accordingly, PCX Holdings will have 100% voting control over the reorganized PCX.⁷⁷ The Certificate of Incorporation of PCX Holdings imposes limitations on direct and indirect changes in control of PCX Holdings through voting and ownership limitations placed on PCX Holdings' capital stock (whether common stock or preferred stock), and allow the Board of Directors of PCX Holdings to monitor potential changes in control through a notification requirement once a threshold percentage of ownership of capital stock is reached.⁷⁸

Specifically, the Certificate of Incorporation of PCX Holdings provides that no Person, either alone or together with its Related Persons, may vote or cause the voting of shares of capital stock or give any proxy or consent with respect to shares representing more than twenty percent (20%) of the voting power of the issued and outstanding capital stock of PCX Holdings.⁷⁹ Furthermore, PCX Holdings Certificate of Incorporation places limitations on 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.

PCX Holdings Certificate of Incorporation also provides that no Person, either alone or

⁷⁶ PCX Bylaws, Article II, Section 2.01.

⁷⁷ The Commission has not formally established the standards for control persons of shareholder-owned national securities exchanges. It expects, however, to consider providing guidance on this issue in the future.

⁷⁸ The Certificate of Incorporation for PCX Holdings requires that any Person, either alone or together with its Related Persons, who at any time owns five percent (5%) or more of then outstanding shares of capital stock and who has the right to vote in the election of the Board of Directors of PCX Holdings, shall, immediately upon so owning five percent (5%) or more of the then outstanding shares of such stock, give the Board of Directors of PCX Holdings written notice of such ownership and update that notice promptly after an ownership change of a specified percentage. PCX Holdings Certificate of Incorporation, Article 9, Section 1(b)(iii) and (iv).

⁷⁹ The terms "Person" and "Related Persons" are defined in Article 9 of PCX Holdings Certificate of Incorporation.

together with its Related Persons may own, directly or indirectly, shares constituting more than forty percent (40%) of the outstanding shares of capital stock of PCX Holdings. PCX Holdings Certificate of Incorporation also provides that if any stockholder votes, sells, transfers, assigns or pledges any shares in violation of the transfer restrictions and voting and ownership concentration limits, then those shares shall be treated as owned by the transferor for all purposes, including, without limitation, voting, payment of dividends, and distributions.⁸⁰ In addition, if any stockholder votes, sells, transfers, assigns or pledges any shares in violation of the transfer restrictions and voting and ownership concentration limits, PCX Holdings has the right to redeem those shares at a price equal to the par value thereof, upon the approval of the Board of Directors. These voting and ownership limitations, however, can be waived by an amendment to the Bylaws of PCX Holdings adopted by its Board of Directors, subject to the Board having determined that such person is not subject to any applicable "statutory disqualification" (within the meaning of Section 3(a)(39) of the Act),⁸¹ and the amendment being approved by the Commission. Any such amendment to PCX Holdings Bylaws would be a proposed rule change that would need to be filed with the Commission. 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.

In addition, PCX Holdings Certificate of Incorporation provides that no Person, either alone or together with its Related Persons, who is a trading permit holder of the reorganized PCX, or an equities trading permit holder of PCX Equities, may own, directly or indirectly, shares constituting more than twenty percent (20%) of an class of capital stock of PCX Holdings.

⁸⁰ PCX Holdings Certificate of Incorporation, Article 9, Section 2.

⁸¹ 15 U.S.C. 78c(a)(39).

The Commission finds that the limitation on ownership of PCX Holdings by 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. However, a member's interest could become so large as to cast doubt on whether the exchange can fairly and objectively exercise its self-regulatory responsibilities with respect to that member. A member that also directly or indirectly controls an exchange might be tempted to exercise that controlling influence by directing the exchange to refrain from diligently surveilling the member's conduct or from punishing any conduct that violates the rules of the exchange or the federal securities laws. An exchange also might be reluctant to surveil and enforce its rules zealously against a member that the exchange relies on as its largest source of capital.⁸²

C. Regulatory Jurisdiction over PCX Holdings

The Commission believes that the terms of PCX Holdings Bylaws provides the Commission with sufficient regulatory jurisdiction over the controlling parties to carry out its oversight responsibilities under the Act. PCX Holdings Bylaws provide that, to the extent that they are related to the activities of the reorganized Exchange, the books, records, premises, officers, directors, agents and employees of PCX Holdings are deemed to be the books, records, premises, officers, directors, agents, and employees of the reorganized Exchange for purposes of and subject to oversight pursuant to the Act.⁸³ This provision would enable the Commission to

⁸² The Commission notes, however, that PCX Holdings should disclose periodically, or otherwise make available upon request, information regarding the number of outstanding shares of capital stock, so that persons with a stake in the capital stock can determine whether they are reaching or have reached any of the thresholds that restrict that person's ability to vote or own the shares or require that person to provide written notice under the Article 9 of the PCX Holdings Certificate of Incorporation.

⁸³ PCX Holdings Bylaws, Article 7, Section 7.03.

exercise its authority under Section 19(h)(4) of the Act⁸⁴ with respect to officers and directors of PCX Holdings, because all such officers and directors, to the extent that they are acting in matters related to Exchange activities, would be deemed to be officers and directors of the reorganized Exchange itself. Furthermore, the books and records of PCX Holdings, to the extent that they are related to the activities of the reorganized PCX, are subject to the Commission's examination authority under Section 17(b)(1) of the Act,⁸⁵ as these records would be deemed to be the records of the Exchange itself.

In addition, pursuant to PCX Holdings Bylaws, PCX Holdings and its officers, directors, employees and agents, by virtue of their acceptance of such position, are deemed to irrevocably submit to the exclusive jurisdiction of the U.S. federal courts, the Commission, and the Exchange for the purposes of any suit, action or proceedings pursuant to the U.S. federal securities laws and the rules and regulations thereunder, arising out of, or relating to, the activities of the reorganized Exchange.⁸⁶ Moreover, PCX 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 Commission, that the suit, action or proceeding is an inconvenient forum or that the venue of the suit, action or

⁸⁴ 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.

⁸⁵ 15 U.S.C. 78q(b)(1).

⁸⁶ PCX Holdings Bylaws, Article 7, Section 7.04.

proceeding is improper, or that the subject matter thereof may not be enforced in or by such courts or agency. Moreover, PCX Holdings Bylaws provide that the officers, directors, employees and agents of PCX Holdings, by virtue of their acceptance of such position, are deemed to agree to cooperate with the Commission and the reorganized Exchange in respect of the Commission's oversight responsibilities with respect to the Exchange and the self-regulatory functions and responsibilities of the Exchange.⁸⁷

The Commission also notes that, even in the absence of these provisions of PCX Holdings Bylaws, Section 20(a) of the Act⁸⁸ provides that any person with a controlling interest in PCX Holdings would be jointly and severally liable with and to the same extent that PCX Holdings 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. The Commission believes that, taken together, these provisions grant the Commission sufficient jurisdictional authority over the controlling persons of PCX Holdings. Moreover, the reorganized Exchange 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.⁸⁹ A failure on the part of the reorganized Exchange to enforce its rules could result in suspension or revocation of

⁸⁷ PCX Holdings Bylaws, Article 7, Section 7.05. The Commission notes that the staff of the Exchange has indicated that it would present to the Board of Directors of PCX Holdings for its approval a proposed new Bylaws provision stating that PCX Holdings would take such action as is necessary to insure that its officers, directors and employees consent to the applicability of Sections 7.03 and 7.04 of the Bylaws with respect to Exchange-related activities. Letter from Kathryn Beck, Senior Vice President, General Counsel, Corporate Secretary and Chief Regulatory Officer, PCX, to Elizabeth King, Associate Director, Division, Commission, dated May 13, 2004.

⁸⁸ 15 U.S.C. 78t(a).

⁸⁹ 15 U.S.C. 78c(a)(27).

registration under Section 19(h)(1) of the Act.⁹⁰

D. Self-Regulatory Function of the Reorganized Exchange

The Rules and Bylaws of the reorganized Exchange reflect its status as a wholly-owned subsidiary of PCX Holdings, under management of the reorganized Exchange's Board of Directors and its designated officers and with self-regulation pursuant to PCX's registration as a national securities exchange under Section 6 of the Act.⁹¹ As a result, the reorganized PCX will retain the self-regulatory organization function for its options business as well as for its subsidiary, PCX Equities.

As the sole owner of PCX, the Commission believes that PCX Holdings' activities with respect to its ownership of PCX must be consistent with PCX's obligations under the Act. Under PCX Holdings Bylaws, PCX Holdings' Board, officers, employees and agents must give due regard to the preservation of the independence of the self-regulatory function of the reorganized PCX and to its obligations to investors and the general public and shall not take any actions that would interfere with the effectuation of any decisions by the Board of Directors of the reorganized PCX relating to its regulatory functions or the structure of the market which it regulates or which would interfere with the ability of the reorganized PCX to carry out its responsibilities under the Act.⁹² In addition, all books and records of the reorganized Exchange 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 PCX Holdings, and the information contained therein, must be retained in confidence by PCX Holdings and the members of its Board and its officers,

⁹⁰ 15 U.S.C. 78s(h)(1).

⁹¹ 15 U.S.C. 78f.

⁹² PCX Holdings Bylaws, Article 3, Section 3.15.

employees, and agents and shall not be used for any non-regulatory purposes. The Commission believes that these provisions, which are designed to acknowledge the need to maintain the independence of the reorganized Exchange's self-regulatory role and protect from improper use information pertaining to the self-regulatory function of the reorganized Exchange, are appropriate.

Further, the Commission notes that the Certificate of Incorporation for the reorganized Exchange expressly requires that the Board of Directors of the reorganized PCX to consider applicable requirements for registration as a national securities exchange under Section 6(b) of the Act,⁹³ including the requirement that the rules of the reorganized PCX be designed to protect investors and the public interest, and the requirement that the reorganized PCX shall 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 rules and regulations thereunder, and with the rules of the reorganized Exchange. In the Commission's view, this provision should serve to remind the Board of Directors that they must consider the interests of all Exchange constituents and the requirements of the Act when taking actions on behalf of the reorganized PCX.

E. Fair Representation

Section 6(b)(3) of the Act⁹⁴ 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

⁹³ 15 U.S.C. 78f.

⁹⁴ 15 U.S.C. 78f(b)(3).

6(b)(1) of the Act requires that an exchange be so organized and have the capacity to be able to carry out the purposes of the Act.

Under the Bylaws of the reorganized PCX, the reorganized Exchange will have not less than eight (8) or more than twelve (12) Directors, with the Board of Directors to consist initially of ten (10) Directors, including the CEO of PCX Holdings. The authorized number of Directors will be as determined from time to time by the Board of Directors of the reorganized PCX. At least fifty percent 50% of the Directors shall be Public Directors.⁹⁵ At least twenty percent 20% of the Directors will consist of individuals nominated by the trading permit holders, with at least one Director nominated by the ETP Holders⁹⁶ of PCX Equities, Inc. and with at least one Director nominated by the OTP Holders of the reorganized PCX (“Permit Holder Directors”). The exact number of Public Directors and Permit Holder Directors will be determined from time to time by the Board of Directors, subject to the percentage restrictions described in proposed Article III, Section 3.02(a) of the reorganized PCX’s Bylaws.

The initial Directors of the reorganized Exchange will consist of individuals nominated by the Nominating Committee of the current PCX in consultation with the CEO and will be approved by the Exchange’s Board of Directors. After the formation of the initial Board of Directors, the Nominating Committee of the Board of Directors of PCX Holdings will nominate Directors for election to the Board of Directors of the reorganized PCX. The reorganized PCX Nominating Committee will nominate the OTP Holder nominee(s) to the Board of Directors.⁹⁷

⁹⁵ PCX Bylaws, Article III, Section 2(a).

⁹⁶ See PCXE Rule 1.1(n) (definition of "ETP Holder").

⁹⁷ The Commission notes that the selection process for the OTP Holder nominee(s) differs from the selection process for the ETP Holder nominee. PCX represents that the ETP Nominee will be appointed to the reorganized PCX Board of Directors as required by the PCX/PCXE Shareholder Voting Agreement.

At the first annual meeting and at each subsequent annual meeting of the Holding Member,⁹⁸ except as otherwise provided by the reorganized PCX's Bylaws, the Holding Member will elect Directors to serve until the next annual meeting or until their successors are elected and qualified. The reorganized PCX Board of Directors will appoint the Chairman of the Board of the reorganized Exchange by majority vote.

In addition, pursuant to the proposed Bylaws of the reorganized PCX, each Board Committee will be comprised of at least fifty percent 50% Public Directors. The Board Appeals Committee will be made up of the OTP Director(s), the ETP Director(s), and all of the Public Directors. The Regulatory Oversight Committee will be made up of all of the Public Directors of the reorganized Exchange. The Audit Committee will be made up of at least three Directors and all must be Public Directors with one at least one having accounting or related financial management expertise. The Compensation Committee will be made up of at least three Directors, but only one non-Public Director may serve on that Committee.

Further, various Options Committees will have representatives of OTP Holders, as well as Public Directors. The Nominating Committee will have seven members consisting of six OTP Holders and one person from the public. The EBCC will be made up primarily of OTP Holders and Allied Persons of an OTP Firm and at least one member of the public will serve on the EBCC.⁹⁹ The OTP Advisory Committee will be made up of OTP Holders and the reorganized Exchange will attempt to have diverse OTP Holder representation of different constituencies on

⁹⁸ The reorganized PCX is a non-stock corporation consisting of a sole member, PCX Holdings. See Bylaws of the reorganized PCX, Article II, Section 2.01 for a definition of Holding Member. Only the Holding Member has any right to take part in the ownership of the Exchange and will be the sole "Corporate Member" of the Exchange, as that term is defined in Article 5 of the reorganized PCX's Certificate of Incorporation.

⁹⁹ The EBCC may, among other things, impose appropriate sanctions including suspension and expulsion where it finds that a violation within the disciplinary jurisdiction of the reorganized Exchange has been committed. See PCX Rule 3.2(b)(1)(B)(iii).

that Committee.

The Commission finds that the requirement that the Board be composed of at least 50% Public Directors is consistent with Sections 6(b)(1) and 6(b)(3) of the Act,¹⁰⁰ which requires that one or more directors be representative of issuers and investors. The Commission also finds that the requirement that the Board of Directors be composed of at least 20% Permit Holder Directors and the manner in which such Directors will be nominated and elected, together with the representation of Permit Holders on key Board and Options Committees, satisfies the fair representation requirements in Section 6(b)(3) of the Act.¹⁰¹ The Commission notes, however, that trading privileges will be separated from corporate ownership of the reorganized Exchange and will be available exclusively through trading permits following the completion of the demutualization. The Commission therefore 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.¹⁰² The Commission also notes that OTP Holders and OTP Firms will retain a voice in the administration of the affairs of the reorganized Exchange, including rulemaking and the disciplinary process, through OTP Holder participation on various Board and Options Committees.

Finally, the Commission notes that the proposed rule change includes revisions to the reorganized Exchange's governance structure to reflect the demutualization. The Commission is in the process of reviewing a range of governance issues relating to self-regulatory organizations and, depending on the results of that review, may determine that further steps designed to strengthen the governance of SROs, including the reorganized Exchange, are necessary.

¹⁰⁰ 15 U.S.C. 78f(b)(3).

¹⁰¹ Id.

¹⁰² Id.

F. Dividends

With the demutualization, the holders of capital stock will have the dividend and other distribution rights of a stockholder in a Delaware stock corporation. The Bylaws of the reorganized Exchange entitles the Holding Member (i.e., PCX Holdings) to receive, at the discretion of the Board of Directors, dividend distributions. The Bylaws further provide that any revenues received by the Exchange from regulatory fees or regulatory penalties will be applied to fund the legal, regulatory, and surveillance operations of the Exchange and will not be used to pay dividends.¹⁰³ This limitation would preclude the reorganized Exchange from providing dividends derived from regulatory fees or penalties to the sole Holding Member of the reorganized Exchange, i.e., PCX Holdings. As a result, PCX Holdings would not be able to provide dividends derived from regulatory fees or penalties belonging to the Exchange to its stockholders. The Commission finds that the prohibition on the use of regulatory fees or penalties to fund dividends is consistent with Section 6(b)(3) of the Act¹⁰⁴ because it will ensure that the regulatory authority of the Exchange is not used improperly to benefit PCX Holdings and its stockholders.

VI. Accelerated Approval of Amendment No. 1

The Commission finds good cause exists for approving Amendment No. 1 to the proposed rule change prior to the thirtieth day after the amendment is published for comment in the Federal Register, pursuant to Section 19(b)(2) of the Act.¹⁰⁵ In Amendment No. 1, PCX clarified rule text, including the usage of terms such as “OTP Holder” and “OTP Firm;” amended

¹⁰³ For purposes of this provision, regulatory penalties include restitution and disgorgement of funds intended for customers.

¹⁰⁴ 15 U.S.C. 78f(b)(3).

¹⁰⁵ 15 U.S.C. 78s(b)(2).

rule text to reflect changes to rules approved by the Commission subsequent to the filing of the proposed rule change; revised rule text to comport more closely with the Rules of the current Exchange; added cross-references to provisions of rules, as appropriate; corrected erroneous references; deleted extraneous provisions; and clarified that the Constitution and Articles of Incorporation of the current Exchange would be deleted.

The Commission notes that generally the revisions to the Rules contained in Amendment No. 1 clarify the Rules as initially proposed; reflect changes to Rules as a result of subsequent Commission action and thus previously were published for comment by the Commission; or amend the Rules in insignificant ways to comport with the demutualization process. As a result, the Commission believes that Amendment No. 1 raises no new issues and that acceleration of the amendment is appropriate.

VII. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the Amendment No. 1 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-PCX-2004-08 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-PCX-2004-08. This file number should be included on the

subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of PCX. 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-PCX-2004-08 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VIII. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁰⁶ that the proposed rule change (SR-PCX-2004-08) be and hereby is approved, and Amendment No. 1 is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰⁷

Jill M. Peterson
Assistant Secretary

¹⁰⁶ 15 U.S.C. 78s(b)(2).

¹⁰⁷ 17 CFR 200.30-3(a)(12).