

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53356; File No. SR-Phlx-2004-37)

February 23, 2006

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 3 Relating to Its Audit Committee

I. Introduction

On May 20, 2004, the Philadelphia Stock Exchange, Inc. (“Phlx” 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 amend the audit committee provisions of the Phlx By-Laws.³ On October 20, 2005, the Exchange filed Amendment No. 1 to the proposed rule change.⁴ The Exchange has proposed: (i) to allow the Exchange’s Board of Governors (“Board”) to increase the size of its audit committee (“Audit Committee”) up to a number to be determined by its Board from time to time; (ii) to require the members of the Audit Committee to be “Independent Governors;” and (iii) to modify and enhance the responsibilities of the Audit Committee.

The proposed rule change, as amended, was published for comment in the Federal Register on November 28, 2005.⁵ The Commission received no comments on the proposal. The Exchange filed Amendment No. 2 to the proposed rule change on February 10, 2006, and submitted its notification of withdrawal of Amendment No. 2 on February 14, 2006. On

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Phlx By-Laws Article X, Sections 10-9(a)-(b).

⁴ In Amendment No. 1, the Exchange added a definition of “independent director” and made technical changes to the proposed rule text, and revised the filing’s purpose section to reflect the addition of the definition of “independent director.”

⁵ See Securities Exchange Act Release No. 52777 (November 16, 2005), 70 FR 71360.

February 15, 2006, the Exchange filed Amendment No. 3 to the proposed rule change.⁶ This order approves the proposed rule change as modified by Amendment No. 1. Simultaneously, the Commission provides notice of filing of, and grants accelerated approval to, Amendment No. 3.

II. Description

The Exchange proposes to amend the Phlx By-Laws, Article X, Section 10-9 to:

(i) permit, but not mandate, the Board to increase the size of the Audit Committee; (ii) require all Audit Committee members to be “Independent Governors” as defined under the proposal; and (iii) modify and enhance the responsibilities of the Audit Committee. Currently, the Audit Committee is required to consist of three members. The Exchange proposes to require that the Audit Committee be composed of at least three members, and to have the Board establish the exact size of the Audit Committee from time to time.

The Exchange also proposes to require all Audit Committee members to be “Independent Governors.” The Exchange proposes to define “Independent Governor” as a member of the Board who has no material relationship with the Exchange or any affiliate of the Exchange, any member of the Exchange or any affiliate of such member, or any issuer of securities that are listed or traded on the Exchange or a facility of the Exchange.⁷ The proposal would define the term “material relationship” as a relationship, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision-making of the Governor. The

⁶ In Amendment No. 3, the Exchange replaced the term “independent director” in the proposed rule text with “Independent Governor,” deleted references to a maximum five person Audit Committee in the description of the proposal, and made clarifying corrections to the proposed rule text.

⁷ The Exchange has cited to the Commission’s proposed rulemaking on the fair administration and governance of self-regulatory organizations for its proposed definitions of “Independent Governor” and “material relationship.” See Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004) (“SRO Governance Proposal”).

Exchange has represented that the Board would determine whether each Audit Committee member is an Independent Governor upon that Governor's nomination to the Audit Committee and thereafter no less frequently than annually and as often as necessary in light of the Governor's circumstances.

The Exchange also proposes to incorporate into the Phlx's By-Laws enhanced Audit Committee duties and responsibilities, including: (i) sole responsibility for appointing, retaining, and replacing its external auditors; (ii) direct oversight over such auditors; (iii) reviewing at least annually the qualification and performance of such auditors; (iv) direct authority to resolve disagreements between management and such auditors regarding financial reporting; (v) responsibility to ensure the rotation of the lead and concurrent auditors every five years and certain other auditors every seven years, with time-out periods; (vi) evaluation of the independence of external auditors, including ensuring that, other than deferred tax and compliance services, external auditors do not engage in certain non-audit services when they conduct audits for the Exchange and approval of non-audit services where appropriate; (vii) establishing procedures for the receipt, retention, and treatment of complaints received by the Exchange regarding accounting, internal accounting controls, or other auditing matters and confidential anonymous submissions by Exchange employees regarding questionable accounting practices; and (viii) determining the appropriate amount of funding to be provided by the Exchange for the purpose of paying compensation to external auditors to prepare or issue an audit report, compensation to advisers to the Audit Committee necessary for it to carry out its duties, and ordinary administrative expenses of the Audit Committee.

The Exchange also proposes to remove the phrase “independent public accountants” from Article X, Section 10-9(b) of the Phlx By-Laws and replace it with the phrase “external auditors,” which would broaden the scope of the Audit Committee’s oversight.

III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a self-regulatory organization.⁸ In particular, the Commission believes that the proposed rule change, as amended, is consistent with Section 6(b)(5) of the Act⁹ in that it is designed to perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest.

The Commission notes that the proposed rule change would require every member of the Audit Committee to be an “Independent Governor,” as such term is defined in the proposal, and also would require the Exchange’s Board to determine the independence of such Governor upon his or her nomination to the Audit Committee and thereafter no less frequently than annually and as often as necessary in light of the Governor’s circumstances. The Commission believes that the Exchange’s proposed definition of Independent Governor is designed to provide parameters for ensuring that disinterested, objective Governors serve on the Audit Committee.¹⁰ Moreover, the definition of Independent Governor and the requirement that the Exchange periodically

⁸ The Commission has considered the proposed rule’s impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

⁹ 15 U.S.C. 78f(b)(5).

¹⁰ The Commission notes that the SRO Governance Proposal also proposed specific circumstances that would preclude a determination that a director is independent, which the Exchange has not incorporated in this proposal. The Commission notes, however, that the Exchange would be required to conform its definition of “Independent Governor,” as well as any other related rules, to any rules that the Commission may adopt in the future with respect to the governance of national securities exchanges and the independence of their directors.

assess the independence of Audit Committee members should help enhance the independence and integrity of the Audit Committee. The Commission also believes that the Phlx's proposed revisions to the Audit Committee's functions should help strengthen the Audit Committee's oversight of the Exchange's audit matters.

The Commission finds good cause for approving proposed Amendment No. 3 before the 30th day after the date of publication of notice of filing hereof in the Federal Register. Phlx filed Amendment No. 3 to replace the term "independent director" in the proposed rule text with the term "Independent Governor," to delete references in the description section of the proposal to an increase in the size of the Audit Committee to a maximum of five persons, and to make clarifying changes and corrections to the proposed rule's text. The Commission believes that the proposed changes in Amendment No. 3 clarify the composition of the Audit Committee and make minor, clarifying corrections to the proposal's rule text, but raise no new issues of regulatory concern. For these reason, the Commission finds good cause for accelerating approval of Amendment No. 3.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment No. 3 is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-Phlx-2004-37 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-Phlx-2004-37. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of Phlx. 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-Phlx-2004-37 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹¹ that the proposed rule change (File No. SR-Phlx-2004-37), as amended by Amendment No. 1, be, and it hereby is, approved, and that Amendment No. 3 to the proposed rule change be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹²

Nancy M. Morris
Secretary

¹¹ 15 U.S.C. 78s(b)(2).

¹² 17 CFR 200.30-3(a)(12).