

List for three months after receipt by the Amex. Fifth, the Commission believes that the procedures Morgan Stanley has established to detect and prevent material non-public information concerning the Index from being improperly used by the person or persons responsible for compiling the Replacement Lists, as well as other persons within Morgan Stanley, as discussed above, adequately serve to minimize the susceptibility to manipulation of the Index, the securities in the Index, and securities added to and deleted from any Replacement List. Finally the ISE's existing surveillance procedures for stock index options will apply to the options on the Index and should provide the ISE with adequate information to detect and deter trading abuses that may occur. In summary, the Commission believes that the procedures outlined above help to ensure that Morgan Stanley will not have any informational advantages concerning modifications to the composition of the Index due to its limited role in consulting with Amex on the maintenance of the Index under certain circumstances.

B. Customer Protection

The Commission believes that a regulatory system designed to protect public customers must be in place before the trading of sophisticated financial instruments, such as Index options, can commence on a national securities exchange. The Commission notes that the trading of standardized exchange-traded options occurs in an environment that is designed to ensure, among other things, that: (1) The special risks of options are disclosed to public customers; (2) only investors capable of evaluating and bearing the risks of options trading are engaged in such trading; and (3) special compliance procedures are applicable to options accounts. Accordingly, because the Index options and Index LEAPS will be subject to the same regulatory regime as the other index options currently traded on the ISE, the Commission believes that adequate safeguards are in place to ensure the protection of investors in the Index options and full-value or reduced value Index LEAPS. Finally, the Amex has stated that it will distribute information circulars to members following rebalancings and prior to component changes to notify members of changes in the composition of the Index. Additionally, the Amex will publicly disseminate each Replacement List by means of information circulars. The Commission believes this should help to protect investors and avoid investor confusion.

C. Surveillance

The Commission believes that a surveillance sharing agreement between an exchange proposing to list a stock index derivative product and the exchange(s) trading the stocks underlying the derivative product is an important measure for surveillance of the derivative and underlying securities markets. Such agreements ensure the availability of information necessary to detect and deter potential manipulations and other trading abuses, thereby making the stock index product less readily susceptible to manipulation. In this regard, the Amex, NYSE, and the NASD are all members of the ISG, which provides for the exchange of all necessary surveillance information.⁴²

D. Market Impact

The Commission believes that the listing and trading of Index options, including full-value and reduced-value Index LEAPS on the ISE will not adversely impact the underlying securities markets. First, as described above, due to the "equal dollar-weighting" method, no one stock or group of stocks dominates the Index. Second, because at each quarterly review and each rebalancing of the Index, at least 90% of the weight of the Index must be accounted for by stocks that meet the Amex's options listing standards, the component stocks generally will be actively-traded, highly-capitalized stocks. Third, the currently applicable 31,500 contract position and exercise limits will serve to minimize potential manipulation and market impact concerns. Fourth, the risk to investors of contra-party non-performance will be minimized because the Index options and Index LEAPS will be issued and guaranteed by the Options Clearing Corporation just like any other standardized option traded in the United States. Lastly, the Commission believes that settling expiring Index options (including full-value and reduced-value Index LEAPS) based on the opening prices of component securities is reasonable and consistent with the Act. As noted in other contexts, valuing options for exercise settlement on expiration based on opening prices rather than closing prices may help reduce adverse effects on markets for stocks underlying options on the Index.

The Commission finds good cause, pursuant to section 19(b)(2) of the Act,⁴³ for approving the proposed rule change, as amended, prior to the 30th day after the date of publication of the notice of the filing thereof in the **Federal**

Register. The Commission previously addressed the issues raised by the trading of the Index on an exchange when the Commission approved this product for trading on the Amex,⁴⁴ and accelerated approval of the proposal will allow investors to begin trading the options promptly. Moreover, the index meets all of the requirements of ISE Rule 2002(b) except for quarterly rebalancing, which the Commission has previously determined was appropriate given the specific procedures in place for quarterly review and maintenance of the Index. Accordingly, the Commission finds that there is good cause, consistent with section 6(b)(5) and 19(b)(2) of the Act,⁴⁵ to approve the proposed rule change, as amended, on an accelerated basis.

V. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,⁴⁶ that the proposed rule change (SR-ISE-2003-36), as amended, is hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁴⁷

Jill M. Peterson,

Assistant Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49451; File No. SR-PCX-2004-08]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Pacific Exchange, Inc. Relating to the Demutualization of the Pacific Exchange, Inc.

March 19, 2004.

Pursuant to Section 19(b)(1) of the Securities Act of 1934 ("Act")¹ and PCX Rule 19b-4 thereunder,² notice is hereby given that on February 10, 2004, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to

⁴⁴ See Amex Approval, *supra* note 4.

⁴⁵ 15 U.S.C. 78f(b)(5) and 78s(b)(2).

⁴⁶ 15 U.S.C. 78s(b)(2).

⁴⁷ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

⁴² See *supra* note 26.

⁴³ 15 U.S.C. 78s(b)(2).

solicit comments on the proposed rule change from interested persons.

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

PCX is proposing 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 ("OTPs").³ To effect this demutualization, a newly-formed Delaware stock corporation called PCX Holdings, Inc. ("PCX Holdings" or "Holding Member") would become a holding company for a newly-created non-stock subsidiary (the "reorganized PCX" or "reorganized Exchange")⁴ and its other operating subsidiaries. The proposal includes new governing documents and rules relating to the Board of Directors of PCX Holdings and the reorganized Exchange, proposed rule changes to the committee structure of the reorganized Exchange, and certain other proposed rules by the reorganized Exchange to regulate the business conduct and practices of persons and entities issued OTPs.

The proposed rule changes for implementing the demutualization, including: (A) The Rules for the reorganized Exchange; (B) the Certificate of Incorporation for PCX Holdings; (C) the Bylaws for PCX Holdings; (D) the Certificate of Incorporation for the reorganized Exchange; and (E) the Bylaws for the reorganized Exchange, are collectively referred to herein as the "proposed rule change" and are available for viewing on the Commission's Web site, <http://www.sec.gov>, and at PCX and the Commission.

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

In its filing with the Commission, PCX included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed

rule change. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

a. Overview of the Proposed Plan of Demutualization. The current PCX, a Delaware non-stock corporation, proposes a plan to "demutualize," whereby it will be reorganized as a subsidiary of a for-profit stock corporation, the stockholders of which will initially be the current owners of the outstanding authorized memberships of the current Exchange. To effect the demutualization, a newly-formed Delaware stock corporation called 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 its equities business subsidiary, PCX Equities, Inc. ("PCX Equities" or "PCXE"). 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 membership interest and, in addition, will receive a trading permit 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,⁵ voting, and liquidation rights. 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.

b. Purpose of the Proposed Plan of Demutualization. PCX believes that 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. Furthermore, PCX 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, the holders of common stock of PCX Holdings will retain, through their ownership of stock, their economic interest in its operating subsidiaries and ultimately will benefit from any improvement in the financial health of these entities resulting from the demutualization.

c. Corporate Structure. i. 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 PCX⁶ 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 its assets to a third party, or to dissolve or liquidate the reorganized PCX. The proposed Certificate of Incorporation and Bylaws of PCX

³ See proposed PCX Rule 1.1(p) (definition of Options Trading Permit ("OTP")); see also proposed PCX Rule 1.1(q) (definition of "OTP Holder") and proposed PCX Rule 1.1(r) (definition of "OTP Firm").

⁴ For purposes of this filing, where the context requires differentiation between PCX before the demutualization and 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."

⁵ PCX notes that it does not currently anticipate that PCX Holdings will pay dividends on its common stock in the immediate future. In the event that a dividend is declared, any revenues received by PCX Holdings or 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.

⁶ This right is subject to Trading Permit Holders' right to nominate their candidates.

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 to consist of initially 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 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 may own shares constituting more than forty percent (40%) of the outstanding shares of capital stock of PCX Holdings. 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),⁷ and the amendment being approved by the Commission. No trading permit holder of the reorganized PCX or equities trading permit holder of PCX Equities may own shares constituting more than twenty percent (20%) of the outstanding shares of common stock of PCX Holdings. Any person that at any time owns 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.⁸

No person may possess the right to vote shares representing more than twenty percent (20%) of the issued and outstanding capital stock of PCX Holdings. This provision can be waived by an amendment to the Bylaws of PCX Holdings approved by the Board of Directors, subject to the 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),⁹ and the amendment being approved by the Commission.

Shares acquired in violation of the transfer restrictions and voting and ownership concentration limits shall be treated by PCX Holdings as owned by the transferor for all purposes, including, without limitation voting, payment of dividends, and distributions.¹⁰ Shares acquired in violation of the transfer restrictions and voting and ownership concentration limits may be redeemed by PCX Holdings at a price equal to the par value thereof, upon the approval of the PCX Holdings Board of Directors.

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. 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

⁷ 15 U.S.C. 78c(a)(39).

⁸ See PCX Holdings Certificate of Incorporation, Article IX, Section 1(b)(iii).

⁹ 15 U.S.C. 78c(a)(39).

¹⁰ See PCX Holdings Certificate of Incorporation, Article IX, Section 2.

to the par value thereof, upon the approval of the PCX Holdings Board of Directors and the Commission.

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.

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,¹¹ unless upon consummation of the transaction which results in the person becoming an interested stockholder, such interested stockholder owned at least 85% of the voting stock of PCX Holdings outstanding at the time the transaction commences, excluding certain shares.¹²

PCX Holdings shall 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 Act. 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.¹³

ii. *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 control over the reorganized PCX. 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 will also have the right to amend the Bylaws of the reorganized PCX.

A. *Governing Documents and PCX Rules.* The proposed Certificate of Incorporation, 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. A detailed description of the proposed new rules for the reorganized PCX is provided in Section 5 of this notice. The proposed reorganized PCX Rules and Bylaws will reflect the status of the reorganized PCX as a wholly-owned subsidiary of PCX Holdings, under management of the reorganized PCX Board of Directors and its designated officers with self-regulation pursuant to PCX's registration under Section 6 of the Act.¹⁴

B. *Board of Directors.* The Board of Directors shall consist of 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 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").¹⁵ 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 Holders¹⁶ 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,¹⁷ 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 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) 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 comprised 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 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

¹¹ See PCX Holdings Bylaws, Article 2, Section 6(b).

¹² PCX represents that this provision is consistent with Section 203 of Title 8 of the Delaware Code. Del. Code, Title 8, section 203. Telephone conversation between Mai Shiver, Acting Director and Senior Counsel, PCX, and Frank N. Genco, Attorney, Division, Commission, on March 3, 2004.

¹³ See PCX Holdings Bylaws, Article 3, Section 15.

¹⁴ 15 U.S.C. 78f.

¹⁵ See PCX Bylaws, Article 3, Section 2(a).

¹⁶ See PCX Rule 1.1(n) (definition of "ETP Holder").

¹⁷ The reorganized PCX is a non-stock corporation consisting of a sole member, PCX Holdings.

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.¹⁸ 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.¹⁹ 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 defined 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.

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.²⁰

F. Disciplinary Process. The reorganized PCX will retain the self-regulatory organization function for the options business of the PCX as well as its equities business subsidiary, PCX Equities. The proposed demutualization will not affect PCX'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 Persons²¹ of an OTP Firm. At least one member of the public shall serve on the EBCC.²²

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.²³ 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. 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

²¹ Allied Person is defined in proposed 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.

²² PCX represents that committees involved in the disciplinary process will remain unaffected by the demutualization.

²³ The OTP Advisory Committee shall act in an advisory capacity regarding rule changes related to disciplinary matters and trading rules. See proposed PCX Rule 3.2(b)(3).

¹⁸ 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.

¹⁹ 15 U.S.C. 78c(a)(39).

²⁰ 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").

reorganized PCX will operate as a national securities exchange registered under Section 6 of the Act.²⁴ 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 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.

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 Act²⁵ and Rule 19b-4 thereunder.²⁶

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") Plan, 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.²⁷ 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.²⁸ Similarly, the reorganized PCX expects that, a representative of the reorganized PCX will serve as its representative with respect to NMS plans that relate to options trading (*i.e.*, OPRA and Linkage).

iii. *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.

d. *Option Trading Permits*.

i. *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,²⁹ PCX Plus,³⁰ or any other systems approved by the Board of Directors, as a Market Maker, Floor Broker or order-flow firm. OTP

²⁸ *Id.*

²⁹ 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.

³⁰ 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).

Holders may engage in trading of options in the same manner as currently practiced by PCX Members who trade on the options trading facility.³¹

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 selected by the CEO of the reorganized PCX.

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

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

iii. *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.

iv. *Non-transferability of OTPs*. OTPs will not be transferable by sale or lease,

³¹ 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.

²⁴ 15 U.S.C. 78f.

²⁵ 15 U.S.C. 78s(b).

²⁶ 17 CFR 240.19b-4.

²⁷ 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.

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.

v. *Cost of OTPs.* Pursuant to the requirements of Section 19 of the Act,³² PCX intends to set forth in a separate rule filing the fees for an OTP that will be assessed.

e. *Proposed PCX 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 proposed rules contain changes to reflect the new structure whereby trading permits will be issued to persons or entities conducting business on the reorganized PCX. Detailed descriptions are provided with respect to those rules that reflect a significant departure from the current PCX Rules. In addition, for those proposed rules that are closely patterned after existing PCX Rules, the PCX indicates which PCX Rules were the model and notes that only minor conforming word changes and clean-up corrections were made.

i. *Summary of Proposed PCX Rules.* Following the demutualization, the reorganized PCX will adopt, subject to certain revisions, the applicable trading rules and standards of the current PCX as they relate to the current options trading business. Proposed PCX Rules 1 through 3, 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. A discussion of the proposed rules follows.

A. *PCX Rule 1—Definitions.* Proposed 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 Option Trading Permits, the PCX has developed the following new terms and incorporated them into Proposed PCX Rule 1.

Proposed PCX Rule 1.1(h)—The term "Exchange" shall mean 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 by Section 6 of the Act.³³

Proposed PCX Rule 1.1(n)—The term "Nominee" means an individual who is authorized by an OTP Firm, in accordance with proposed PCX Rule 2.4, to conduct business on the Exchange's Trading Facilities 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.³⁴ A Nominee shall agree to be bound by the Bylaws and Rules of the Exchange, and by all applicable rules and regulations of the Commission.

Proposed PCX Rule 1.1(p)—The term "OTP" shall refer 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,³⁵ and which has been approved by the Exchange.

Proposed PCX Rule 1.1(q)—The term "OTP Holder" shall refer 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 registered broker or dealer pursuant to Section 15 of the Act,³⁶ 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.³⁷

Proposed PCX Rule 1.1(r)—The term "OTP Firm" shall refer 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.³⁸ 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 proposed 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.³⁹

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

Proposed PCX Rule 1.1(aa)—The term "Trading Facilities" shall refer 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.* Proposed PCX Rule 2, which describes the application process, the qualification requirements and other requirements for holding an OTP, are similar to the requirements and procedures now described in current PCX Rule 1 and certain sections of the current PCX Constitution. However, as we describe below, certain substantive changes have been made to reflect the characteristics of the new OTPs. These substantive changes include the following:

Proposed PCX Rule 2.2—In accordance with proposed 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 proposed 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, 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

³² 15 U.S.C. 78s.

³³ 15 U.S.C. 78f.

³⁴ 15 U.S.C. 78c.

³⁵ 15 U.S.C. 78o.

³⁶ 15 U.S.C. 78o.

³⁷ 15 U.S.C. 78c.

³⁸ 15 U.S.C. 78o.

³⁹ 15 U.S.C. 78c.

pursuant to PCXE's standard application procedures.

Proposed PCX Rule 2.3—In order to be consistent with the approach taken with respect to seat ownership, under proposed 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, which casts the vote. However, pursuant to proposed 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.

Proposed PCX Rules 2.4, 2.5, and 2.6—Proposed 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 proposed 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 with the proposed restructuring.

Proposed PCX Rule 2.21—As described in proposed PCX Rule 2.21(a) and (b), unlike current PCX memberships, OTPs may not be purchased, sold or leased. Therefore, proposed PCX Rules 1.21 and 1.24 and sections of proposed PCX Rules 1.22 and 1.23 relating to the purchase, sale, or lease of memberships have been deleted from the reorganized PCX Rules. Under proposed PCX Rule 2.21(c), 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 of 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.

Proposed PCX Rule 2.22—Pursuant to proposed 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.

PCX represents that, other than the substantive changes discussed above and minor conforming word changes that reflect the demutualization, each section of proposed 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.

C. PCX Rule 3—Organization and Administration

Proposed PCX Rule 3 sets forth the organization and governance structure of the reorganized PCX. Proposed PCX Rules 3.1 through 3.3 regarding Options and Board Committees were drafted using current PCX and PCXE Rules as a starting point.⁴⁰ Under the proposed rules, the use of a "member" committee structure will be substantially reduced.

Proposed PCX Rule 3.1—Proposed 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 Board may establish additional Options Committees under this proposed rule, the proposed Bylaws and Rules of the reorganized PCX currently envision only a Nominating Committee, Ethics and Business Conduct Committee, and OTP Advisory Committee. Similarly, although the Board may establish additional Board Committees, the proposed rules currently envision only a Board Appeals Committee, Regulatory Oversight Committee, Audit Committee, and Compensation Committee.

Proposed PCX Rule 3.2(a)—Proposed PCX Rule 3.2(a) establishes the substantive and procedural rules for an Options Committee conducting meetings and exercising its authority. In particular, proposed PCX Rule 3.2(a), which is similar to existing PCX and PCXE rules and procedures, 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 the proposed rule, OTP Holders and Allied Persons⁴¹ 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 shall be eligible for service on the same Options Committee. Proposed PCX Rule 3.2(a) would vest authority in the Board of Directors or such other designee of the reorganized PCX to appoint the members of Options Committees (other than the Nominating Committee). The CEO or such other designee of the reorganized PCX shall appoint the Chair and Vice Chair of each Options Committee (other than the Nominating Committee).

Proposed PCX Rule 3.2(b)(1)—Proposed 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 to: (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 proposed 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 proposed 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

⁴⁰ See PCX Rules 11.1(a)–(b), 11.2(a)–(b), 11.3–11.5, 11.6(b); 11.8(d), PCX Constitution Articles II–IV, and PCXE PCX Rule 3.

⁴¹ See *supra* note 18.

unless specifically allowed by the Board. A person or firm which 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 proposed PCX Rule 10.

Proposed PCX Rule 3.2(b)(2)—Proposed PCX Rule 3.2(b)(2) describes the characteristics and function of the Nominating Committee. Specifically, the Nominating Committee will 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 proposed 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 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.⁴² 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 defined 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.

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 respective Board at its first meeting following the election.

Proposed PCX Rule 3.2(b)(3)—The proposed 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 shall 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.

Proposed PCX Rule 3.2(c)—Under this proposed rule, each Options Committee shall 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.

Proposed PCX Rule 3.3(a)(1)—Proposed PCX Rule 3.3(a)(1) describes the functions and authority of the Board Appeals Committee. The Board Appeals Committee shall be made up 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”) shall be made up of members of the Board Appeals Committee. An Appeals Panel shall be made up of no less than three (3), but no more than five (5) individuals.⁴³ 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 proposed PCX Rule 10, decisions of the Board Appeals Committee shall be subject to the review of the Board of Directors. The decision of the Board of Directors shall constitute the final action of the Exchange, unless the Board remands the proceedings.

Proposed PCX Rule 3.3(a)(2)—Proposed 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 made up of all the Public Directors of the reorganized PCX.

Proposed PCX Rule 3.3(a)(3)—Proposed 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

⁴³ The body conducting the review, either the Board Appeals Committee itself or the Appeals Panel, is also referred to in the proposed rules as the Review Board.

⁴² 15 U.S.C. 78c(a)(39).

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.

Proposed PCX Rule 3.3(a)(4)—Proposed 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 shall also make recommendations to the Board of Directors of the reorganized PCX with respect to the design of incentive compensation and equity-based plans.

Proposed PCX Rule 3.6—Subject to minor word changes, proposed PCX Rule 3.6 regarding surveillance agreements is the same as existing PCX Rule 14.1.

Proposed PCX Rules 3.7–3.9—Other than minor conforming word changes, proposed PCX Rules 3.7 through 3.9 are the same as current PCX Constitution Article XIV, Section 1. Under these rules, the reorganized PCX Board may impose reasonable fees, assessments, charges, or fines to be paid by OTP Holders or OTP Firms. Prior to implementing the demutualization, PCX represents that 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. Proposed PCX Rule 4, which sets forth the net capital, financial reporting, and margin requirements for OTP Holders and OTP Firms, has been adapted from current PCX Rule 2. Only minor conforming changes in terminology and clean-up corrections have been made to the current PCX Rules.

E. PCX Rule 5—Listings. Proposed 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 proposed rule has been adapted from current PCX Rules 3, 7, and 8. Only minor conforming changes in terminology and clean-up corrections have been made to the current PCX Rules.

F. PCX Rule 6—Options Trading. Other than the substantive changes discussed below and minor conforming word changes that reflect the demutualization, proposed PCX Rule 6 is the same as the current PCX Rule 6 governing options trading. Accordingly, the Exchange proposes to modify PCX Rule 6 in order to make two notable modifications to its options trading rules. First, the Exchange seeks to confer jurisdiction currently held by the Options Floor Trading Committee to the Exchange, and, second, the Exchange proposes to confer jurisdiction currently held by Floor Officials to either Trading Officials or the Exchange.⁴⁴

G. PCX Rule 7—General Trading PCX Rules. Proposed PCX Rule 7, which pertains to general trading rules that address trading hours, access to trading facilities, etc., has been adapted from current PCX Rule 4. Only minor conforming changes in terminology have been made to the current PCX Rules.

H. PCX Rule 9—Conducting Business with the Public. Proposed PCX Rule 9, which governs how OTP Holders and OTP Firms must conduct business with the public, is patterned after existing PCX Rule 9. Except for minor changes in terminology and clean-up corrections, the proposed rule is substantially the same as the existing rule.

I. PCX Rule 10—Disciplinary Proceedings, Other Hearings, and Appeals. Proposed PCX Rule 10 describes the disciplinary process for the reorganized PCX. The reorganized PCX's disciplinary process will be similar to the existing PCX disciplinary

process (including summary sanction procedures under the Minor PCX Rule Plan) and will be governed by the Ethics and Business Conduct Committee. Therefore, aside from conforming word changes and the substantive changes discussed below, proposed PCX Rule 10 will be closely modeled after existing PCX Rule 10.

Proposed PCX Rules 10.8(a)—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 Ethics and Business Conduct Committee.⁴⁵ The respondent may appeal to the Board at any time within fifteen (15) calendar days after the decision has been served.

Proposed PCX Rule 10.8(b)—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)—Current PCX Rules 11.7(a)–(m) regarding appeals for non-disciplinary matters will be incorporated into proposed PCX Rule 10.14. Proposed 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 Exchange; (5) actions taken pursuant to proposed 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 (proposed PCX Rules 6.33, 6.44 and

⁴⁴ 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. The Commission notes that the Exchange committed to file a proposed rule change under Section 19(b) of the Act with respect to any proposal to permit PCX's regulatory staff to assume responsibilities handled by Trading Officials. Telephone Conversation on March 17, 2004.

⁴⁵ The Exchange is proposing to make certain technical changes throughout the text of the proposed PCX Rule 10 for clarification purposes, e.g., changing the reference to calendar days.

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

K. Rule 12—Arbitration. Proposed PCX Rule 12, the arbitration rule, has been patterned closely after current PCX Rule 12. Only minor changes in terminology have been made to conform the proposed rule to the circumstances of the proposed demutualization.

L. PCX Rule 13—Expulsion, Suspension, and Reinstatement. Proposed PCX Rule 13 clarifies, restates, and reorganizes existing PCX Rules and procedures regarding certain suspensions, cancellations, bars, and prohibitions on access to the reorganized PCX services and facilities. The following describes the proposed rules and how they differ from existing rules, where applicable.

Proposed PCX Rules 13.1(a)–(b)—Proposed PCX Rules 13.1(a)–(b) incorporate a modified version of Article X, Sections 1(a) and (b) of the current PCX 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.

Proposed PCX Rules 13.2(a)–(b)—PCX has reorganized and simplified its Rules relating to summary and non-summary disciplinary proceedings. The proposed PCX Rules have been adapted from NASD Rule 9510 Series and current PCX Constitution, Article X, Section 2 and Article XI, Section 3(c). These proposed sections are intended to eliminate any potential ambiguities in the procedures related to summary and non-summary suspensions by expressly identifying the grounds for imposing such suspensions.

Proposed PCX Rule 13.2(c)—Proposed PCX Rule 13.2(c) provides that action taken pursuant to PCX Rule 13.2(a) shall also be subject to the applicable provisions of proposed PCX Rule 10.14. Furthermore, under proposed

Commentary .01, the Exchange will be required to notify the Commission in the event that it determines to take summary action pursuant to proposed PCX Rule 13.2.

Proposed PCX Rule 13.3—Proposed PCX Rule 13.3 states that an OTP Holder, OTP Firm, or associated person 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.

Proposed PCX Rule 13.4—Proposed 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.

Proposed PCX Rule 13.5—Other than minor word changes, proposed PCX Rule 13.5 is modeled closely after Article X, Section 3 of the current PCX Constitution. Proposed PCX Rule 13.5 states that a person or organization whose trading privileges have been suspended must immediately allow the reorganized Exchange to investigate its affairs.

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

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

Proposed PCX Rule 13.8—Proposed PCX Rule 13.8 provides that if any OTP Holder, OTP Firm, or any other 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. Proposed PCX Rule 14 has been adapted from current PCX Rule 13. Only minor changes in terminology have been made to conform the rule to the proposed demutualization.

N. Option Floor Procedure Advices (“OFPA”). This section of the proposed rules contains the various options floor procedures and policies that have been adopted over time. These proposed rules have been adapted from the existing ones, which were previously approved by the Commission. These

policies 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.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act,⁴⁶ in general, and furthers the objectives of Sections 6(b)(5),⁴⁷ in particular, because it is designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism for a free and open market and a national market system, and to protect investors and the public interest. In addition, the Exchange believes that the proposed rule change is consistent with the provisions of Section 11A(a)(1)(B)⁴⁸ of the Act.

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

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

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

Written comments were neither solicited nor received with respect to the proposed rule change.

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

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

A. By order approve such proposed rule change, or

⁴⁶ 15 U.S.C. 78f(b).

⁴⁷ 15 U.S.C. 78f(b)(5).

⁴⁸ 15 U.S.C. 78k(a)(1)(B).

B. Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments should be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. 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 comments more efficiently, comments should be sent in hard copy or by e-mail but not by both methods. 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 will also be available for inspection and copying at the principal office of the PCX. All submissions should be submitted by April 19, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁴⁹

Margaret H. McFarland,
Deputy Secretary.

[FR Doc. 04-6817 Filed 3-26-04; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49455; File No. SR-PCX-2003-60]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change and Amendment Nos. 1, 2, and 3 by the Pacific Exchange, Inc. Relating to Rules for Trading Index Options

March 22, 2004

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on October 28, 2003, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. On December 18, 2003, the Exchange submitted Amendment No. 1 to the proposed rule change.³ On March 2, 2004, the Exchange submitted Amendment No. 2 to the proposed rule change.⁴ On March 22, 2004, the Exchange submitted Amendment No. 3 to the proposed rule change.⁵ The Commission is publishing this notice to solicit comments on the proposed rule, as amended, from interested persons and is approving the proposed rule change, as amended, on an accelerated basis.

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

The PCX is proposing to amend the position and exercise limits with respect to broad-based index options, as well as a number of conforming changes in order to bring the PCX index option rules up to date with those of other Self-Regulatory Organizations ("SRO"). The proposed rule change is substantially similar to the proposed rules recently filed by the ISE, which were approved by the Commission.⁶

¹ 15 U.S.C. 78s(b)(1).

² 2 CFR 240.19b-4.

³ See letter from Tania J.C. Blanford, Staff Attorney, Regulatory Policy, PCX to Nancy J. Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated December 17, 2003. Amendment No. 1 replaced the original rule filing in its entirety.

⁴ See letter from Tania J.C. Blanford, Staff Attorney, Regulatory Policy, PCX to Nancy J. Sanow, Assistant Director, Division, Commission, dated March 1, 2004 ("Amendment No. 2"). In Amendment No. 2, the PCX made several changes to the proposed rule change to conform the proposed rule text to the existing Chicago Board Options Exchange, Inc. ("CBOE") and International Securities Exchange, Inc. ("ISE") rules. In addition, the Exchange clarified the classes of broad-based index options for which the CBOE Rules prescribe no position limits, and described that its proposed Rule 6.11(b) provided for the procedure that underwriters follow when requesting restrictions on uncovered opening writing transactions during public distributions.

⁵ See letter from Tania J.C. Blanford, Staff Attorney, Regulatory Policy, PCX to Nancy J. Sanow, Assistant Director, Division, Commission, dated March 22, 2004 ("Amendment No. 3"). In Amendment No. 3, the PCX corrects certain typographical errors.

⁶ See Securities Exchange Act Release No. 48405 (August 25, 2003), 68 FR 52257 (September 2, 2003) (SR-ISE-2003-05) (Order approving the ISE's proposed rules).

The text of the proposed rule change appears below. Additions are *italicized*; deletions are in [brackets].

* * * * *

Rule 6 Options Trading

Rule 6.8 Position Limits

(a) (No change.)

Commentary:

.01-.03—(No change.)

.04 The Exchange may establish higher position limits for Market Maker transactions than those applicable with respect to other accounts. Whenever a Market Maker reasonably anticipates that he or she may exceed such position limits in the performance of his or her function of assisting in the maintenance of a fair and orderly market, he or she must consult with and obtain the prior approval of an Options Floor Official. *An exemption will generally be granted only to a Market Maker who has requested an exemption, who is appointed to the options class in which the exemption is requested, whose positions are near the current position limit, and who is significant in terms of daily volume. The positions must generally be within ten percent (10%) of the limits contained in Rule 6.8, Commentary .05 for equity options and twenty percent (20%) of those limits for broad-based index options.*⁷

* * * * *

Rule 6.11 Other Restrictions on Exchange Option Transactions and Exercises

(a) The Exchange shall have the power to impose, from time to time in its discretion, such restrictions on Exchange option transactions or the exercise of option contracts in one or more series of options of any class dealt in on the Exchange as it deems advisable in the interests of maintaining a fair and orderly market in option contracts or in the underlying stocks or Exchange-Traded Fund Shares covered by such option contracts, or otherwise deems advisable in the public interest or for the protection of investors.

(1) During the effectiveness of any such restriction, no member organization shall effect any Exchange option transaction or exercise any option contract in contravention of such restriction.

(2) Notwithstanding the foregoing, during the ten (10) business days prior to the expiration date of a given series of options, *other than index options*, no restriction on the exercise of option contracts *under this Rule* shall remain in effect with respect to that series of

⁷ See *supra* note 4.

⁴⁹ 17 CFR 200.30-3(a)(12).