

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-51029; File No. SR-ISE-2004-29]

### Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 to the Proposed Rule Change by the International Securities Exchange, Inc., Relating to Proposed Amendments to Its Certificate of Incorporation and Constitution and ISE Rule 303

January 12, 2005.

#### I. Introduction

On October 22, 2004, the International Securities Exchange, Inc., (“Exchange” or “ISE”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934<sup>1</sup> (“Act”), and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend its Certificate of Incorporation (“Certificate of Incorporation”) and Constitution (“Constitution”). The proposed rule change was published for comment in the **Federal Register** on November 12, 2004.<sup>3</sup> On December 21, 2004, ISE filed Amendment No. 1 to the proposal. On December 22, 2004, ISE withdrew Amendment No. 1 and filed Amendment No. 2 to the proposal.<sup>4</sup> No comment letters were received on the

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 50641 (November 5, 2004), 69 FR 65481.

<sup>4</sup> In Amendment No. 2, ISE made typographical corrections to the proposed Amended and Restated Certificate of Incorporation (the “Amended Certificate”) and proposed Amended and Restated Constitution (“Amended Constitution”), previously filed as part of the proposal, and revised Section 2 of its Form 19b-4 (Procedures of the Self-Regulatory Organization) to reflect actions by the ISE Board and ISE’s stockholders approving the final forms of the Amended Certificate and Amended Constitution. In Amendment No. 2, ISE also proposed changes to ISE Rule 303(b) to incorporate the 20% limit on the number of trading rights associated with ISE’s Series B-1 and Series B-2 Common Stock that may be exercised by a Member of ISE that currently is imposed by Section 14(b) of the Constitution, and amended related portions of its Form 19b-4. Exhibit 5 to Amendment No. 2, which sets forth the text of the Amended Certificate, the Amended Constitution and Rule 303, as proposed to be amended, is available on the Commission’s Web site (<http://www.sec.gov/rules/sro.shtml>), at the Commission and at ISE. The complete text of Amendment No. 2 is available at the Commission and the ISE.

At the request of the ISE, the Commission staff corrected the description of certain typographical corrections to the amended rule text provided in Amendment No. 2. Telephone conversation between Katherine Simmons, Vice President and Assistant Secretary, ISE and Jennifer C. Dodd, Attorney, Division of Market Regulation, Commission on January 4, 2005.

proposed rule change. This order approves the proposed rule change, as amended.<sup>5</sup>

#### II. Description of Proposed Rule Change

The purpose of the proposed rule change is to amend ISE’s Certificate of Incorporation and Constitution (also serving as the Exchange’s bylaws), as well as ISE Rule 303, in connection with ISE’s contemplated initial public offering (“IPO”) of its Class A common stock, par value \$.01 per share (the “Class A Common Stock”), of the Exchange.<sup>6</sup> The Exchange represents that the proposed rule change, if approved, would become effective concurrently with the IPO.<sup>7</sup>

Following the IPO, the Exchange will continue to operate as a registered “national securities exchange” under Section 6 of the Act,<sup>8</sup> and will maintain its current regulatory authority over its members. All persons using the Exchange will continue to be subject to the Exchange’s rules. The Exchange also will continue to interpret its rules to require that any revenues it receives from regulatory fees or regulatory penalties will be segregated and applied to fund the legal, regulatory and surveillance operations of the Exchange and will not be used to pay dividends to the holders of Class A Common Stock.<sup>9</sup> Certain of the proposed changes to the Certificate of Incorporation and Constitution, as well as the proposed changes to ISE Rule 303, are intended to ensure that the IPO of the Exchange will not unduly interfere with or restrict the ability of the Exchange or the Commission to effectively carry out their respective regulatory oversight responsibilities under the Act and generally to enable the Exchange to operate in a manner that complies with the federal securities laws, including furthering the objectives of Section

<sup>5</sup> The proposed rule change includes the Amended Certificate, Amended Constitution (also serving as the “Exchanges Bylaws”), and proposed amendments to Rule 303.

<sup>6</sup> Separately, the Exchange also is contemplating a reorganization into a holding company structure, the completion of which is contingent upon receipt of a favorable tax ruling from the Internal Revenue Service and Commission approval. The Exchange will separately file a proposed rule change seeking Commission approval of that reorganization. The Exchange currently anticipates that the reorganization will occur sometime following the IPO.

<sup>7</sup> In connection with the proposed IPO, the Exchange filed a registration statement on Form S-1 with the Commission on July 2, 2004 (File No. 333-117145); as amended from time to time (the “Registration Statement”).

<sup>8</sup> 15 U.S.C. 78f.

<sup>9</sup> The Exchange adopted this interpretation in connection with its demutualization in 2002. See Securities Exchange Act Release No. 45803 (April 23, 2002), 67 FR 21306 (April 30, 2002).

6(b)(5) of the Act.<sup>10</sup> ISE also represents that some of the proposed changes to the Certificate of Incorporation and Constitution are intended to facilitate the IPO or otherwise relate to the Exchange’s status as a public company following its IPO.

#### A. Current Capital Stock and Board Structure of ISE<sup>11</sup>

The Exchange currently has two classes of common stock, Class A Common Stock and Class B common stock, par value \$.01 per share (“Class B Common Stock”).<sup>12</sup> The Class A Common Stock has the traditional features of common stock, including voting, dividend and liquidation rights.<sup>13</sup> Subject to certain limitations, holders of Class A Common Stock are entitled to vote on all matters submitted to stockholders for a vote.<sup>14</sup>

The Exchange has three series of Class B Common Stock, each series representing certain trading rights and privileges and limited voting rights. Ownership of the Class B Common Stock, Series B-1 (“Series B-1 Common Stock”), is a predicate to obtaining the trading rights and privileges associated with a Primary Market Maker.<sup>15</sup> Ownership of the Class B Common Stock, Series B-2 (“Series B-2 Common Stock”), is a predicate to obtaining the trading rights and privileges associated

<sup>10</sup> 15 U.S.C. 78f(b)(5).

<sup>11</sup> For a discussion of the Exchange’s current capital board structure, see Securities Exchange Act Release No. 45803, *supra* note 9.

<sup>12</sup> The Exchange represents that some owners of shares of Class A Common Stock also own shares of Class B Common Stock. For a list of principal stockholders and their ownership of Class A and Class B Common Stock, see the Registration Statement, “Principal and Selling Stockholders.”

<sup>13</sup> The Amended Certificate will clarify that, as is currently the case, holders of shares of Class A Common Stock are entitled to all residual interests in the event of a liquidation, winding up or dissolution of the Exchange after payment of or provision for the obligations of the Exchange, any preferential amounts payable to holders of shares of preferred stock and amounts payable to the holders of any outstanding shares of Class B Common Stock.

<sup>14</sup> For the provisions relating to the Class A Common Stock, see Certificate of Incorporation, Article Fourth, Subdivision II(a). The holders of shares of Class A Common Stock are not entitled to vote with respect to the Core Rights (as defined in note 19, *infra*), the definition of “Core Rights,” or the election of Industry Directors (as defined herein, see *infra* note 22 and accompanying text).

<sup>15</sup> “Primary Market Makers” are market makers with significant responsibilities, including overseeing the opening of trading in their assigned options classes, providing continuous quotations in all of their assigned options classes, and handling customer orders that are not automatically executed. See Chapter 8 of the ISE Rules and the Registration Statement, “Business,” for a discussion of the role of Primary Market Makers on the Exchange.

with a Competitive Market Maker.<sup>16</sup> Ownership of the Class B Common Stock, Series B-3 (the "Series B-3 Common Stock"), is a predicate to obtaining the trading rights and privileges associated with an Electronic Access Member.<sup>17</sup>

The holders of the Class B Common Stock are not entitled to receive dividends; rather, the holders of such stock are only entitled to receive an amount equal to the par value of each share of Class B Common Stock (*i.e.*, \$.01) held upon the liquidation, dissolution or winding up of the Exchange.<sup>18</sup> Also, such holders are entitled to vote on the election of directors representing the applicable series of Class B Common Stock, with each series of Class B Common Stock being entitled to elect two directors to the Board of Directors of ISE (the "ISE Board").

The owners of Series B-1 Common Stock and Series B-2 Common Stock also are entitled to vote on any change in, or amendment or modification to, the "Core Rights"<sup>19</sup> or the definition of Core Rights. In such a case, the Exchange must obtain the approval of the holders of a majority of both the of Series B-1 Common Stock and the Series B-2 Common Stock, each voting as a separate class with respect to such action.<sup>20</sup>

<sup>16</sup> "Competitive Market Makers" are market makers that add depth and liquidity to the market and are required to provide continuous quotations in at least 60% of the options classes in their assigned group. See Chapter 8 of the ISE Rules and the Registration Statement, "Business," for a discussion of the role of Competitive Market Makers on the Exchange.

<sup>17</sup> "Electronic Access Members" are broker-dealers that represent agency and proprietary orders on the Exchange, and cannot enter quotations or otherwise engage in market making activities on the Exchange. See Chapter 8 of the ISE Rules and the Registration Statement, "Business," for a discussion of the role of Electronic Access Members on the Exchange.

<sup>18</sup> The Amended Certificate will clarify that, as is currently the case, such amount will be paid before any proceeds from the liquidation, dissolution or winding up of the Exchange are paid to the holders of Class A Common Stock.

<sup>19</sup> "Core Rights" as defined in Article Fourth, Subdivision II(a)(i) of the Certificate of Incorporation means any "increase in the number of authorized shares of the Series B-1 Stock or the Series B-2 Stock."

<sup>20</sup> For the provisions relating to the Class B Common Stock, see Certificate of Incorporation, Article Fourth, Subdivision II(b). The Amended Certificate proposes to make certain technical amendments to clarify that, as is currently the case, neither the holders of Class A Common Stock nor the holders of Series B-3 Common Stock are entitled to vote on the Core Rights.

Additionally, the vote required with respect to the Core Rights would be increased from a majority of the votes cast by each of the holders of the Series B-1 Stock and Series B-2 Stock to a majority of the then outstanding shares of each of the Series B-1 Stock and Series B-2 Stock. See Amended

The ISE Board consists of 15 members, eight of whom are elected by the holders of the Class A Common stock (the "Non-Industry Directors"),<sup>21</sup> six of whom are elected by the holders of the Class B Common Stock (the "Industry Directors")<sup>22</sup> and the Chief Executive Officer of the Exchange. In accordance with the current Certificate of Incorporation and Constitution of the Exchange, each director, other than the Chief Executive Officer, holds office for a term of two years.<sup>23</sup> The Chief Executive Officer holds office for a term of one year, or such earlier time as such person no longer serves as Chief Executive Officer. The directors, other than the Chief Executive Officer, are divided into two classes, designated as Class I and Class II directors.<sup>24</sup> At each annual meeting of stockholders, the successors of the class of directors whose term expires at that meeting will be elected to hold office for a term

Certificate, Article Fourth, Subdivision II(a) and (b). As is now the case, any increase or decrease in the overall number of authorized shares of Class B Common Stock would require approval of the holders of a majority of the outstanding shares of Class A Common Stock, voting as a separate class, and the holders of a majority of the outstanding shares of Series B-1 Stock and Series B-2 Stock, voting together as a separate class; any decrease in the number of authorized shares of Series B-1 Stock or Series B-2 Stock would require approval of the holders of a majority of the outstanding shares of Class A Common Stock; and any increase or decrease in the number of authorized shares of Series B-3 Stock would require approval of the holders of a majority of the outstanding shares of Class A Common Stock. The Exchange also may issue preferred stock in the future, the terms of which would be determined by the ISE Board, subject to Commission approval. See Certificate of Incorporation, Article Fourth, Subdivision I.

<sup>21</sup> Nominees for election to the ISE Board to serve as Non-Industry Directors are currently made by the Exchange's Corporate Governance Committee, on which all of the Non-Industry Directors serve. Stockholders also may nominate Non-Industry Director candidates for election to the ISE Board by petition. See Section 3.10 of the Constitution.

<sup>22</sup> Nominees for election to the ISE Board to serve as Industry Directors are currently made by the Exchange's Nominating Committee, which is not a committee of the ISE Board, and is comprised of representatives of the holders of each series of Class B Common Stock. Stockholders also may nominate Industry Director candidates for election to the ISE Board by petition. See Section 3.10 of the Constitution.

<sup>23</sup> The Amended Certificate would clarify that the ISE Board is authorized to fill any vacancies on the ISE Board. See Amended Certificate, Article Fourth, Subdivision II(a)(i) and (b)(v)(A). The Amended Certificate also would provide that directors may only be removed for cause by the stockholders to the extent permitted under applicable law, and not by a vote of two-thirds of the directors as is currently the case. See Amended Certificate, Article Fifth, paragraph (b).

<sup>24</sup> For a list of the Exchange's current directors and their respective classes, see Registration Statement, "Management." As currently and prospectively constructed, each class will be composed of half of the Non-Industry Directors and half of each of the Series B-1, Series B-2 and Series B-3 directors.

expiring at the annual meeting of stockholders held in the second year following the year of their election, and until their successors are elected and qualified. Directors, other than the Chief Executive Officer, may not hold office for more than three consecutive terms.<sup>25</sup>

In addition, the Exchange currently has an Audit Committee (which is proposed to be renamed as the Finance & Audit Committee), a Corporate Governance Committee and a Compensation Committee, all of which are governed by charters.<sup>26</sup>

#### B. Proposed Amendments to Certificate of Incorporation and Constitution

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

- Increase the number of authorized shares of Class A Common Stock from 5,000,000 to 150,000,000;
- Remove the term limits of the Non-Industry Directors;
- Adopt certain limitations on the ownership and voting of shares of Class A Common Stock and of Class B Common Stock;
- Require the Board to consider applicable requirements of the Act in managing the business and affairs of the Exchange;
- Clarify that the Exchange has a Corporate Governance Committee and Compensation Committee, and that these committees, as well as the Finance & Audit Committee of the Exchange, are governed by charters;
- Adopt certain anti-takeover provisions, including with respect to the nomination of Non-Industry Directors by the holders of Class A Common Stock; and
- Reduce the vote of the holders of Class A Common Stock required to amend certain provisions of the Amended Constitution from two-thirds of the outstanding shares of Class A Common Stock to a majority of such shares.<sup>27</sup>

<sup>25</sup> For the provisions relating to the ISE Board, see Certificate of Incorporation, Article Fifth and Constitution, Section 3.2.

<sup>26</sup> For a discussion of these committees and their responsibilities, see Registration Statement, "Management." The Exchange represents that the ISE Board designated these committees pursuant to its authority under Section 5.1 of the Constitution, though the Corporate Governance and Compensation Committees are not specifically designated in the current Constitution itself.

<sup>27</sup> The Exchange also would correct certain typographical and grammatical errors, eliminate outdated or irrelevant references and make certain non-material changes to the Certificate of Incorporation and Constitution. Such changes include, among others, the flexibility to provide notice of ISE Board meetings by several alternate means (see Section 3.6 of the Amended Constitution); the empowerment of the ISE Board

The Exchange also proposes to amend ISE Rule 303 to provide for certain member trading concentration limits with respect to shares of Class B Common Stock currently provided for in the Constitution, as discussed below.

#### 1. Increase in Number of Authorized Shares of Class A Common Stock of ISE

The Exchange proposes to increase the number of authorized shares of ISE's Class A Common Stock in the Amended Certificate from 5,000,000 to 150,000,000.<sup>28</sup> The Exchange represents that this increase will provide the ISE Board with the flexibility to declare a stock dividend that, in the opinion of the underwriters of its IPO, will be sufficient to result in an appropriate market price per share of the Class A Common Stock. The Exchange also represents that the increase in the number of authorized shares of Class A Common Stock will provide shares: (1) To be offered in ISE's IPO, as well as additional shares that can be used by the Exchange for future acquisitions that may be approved by the Board (and by Class A stockholders to the extent required by the rules of the marketplace for the shares of Class A Common Stock); and (2) to be used by ISE for stock options, stock purchase and other equity compensation plans that are approved by the ISE Board (and by Class A stockholders to the extent required by the rules of the marketplace for the shares of Class A Common Stock).

#### 2. Change in the Term Limits of the ISE Board

The Exchange represents that in order to maintain continuity with respect to its Non-Industry Directors during the transition of the Exchange to a public company, the Exchange proposes that the three-term limit (a total of six years of service) currently in the Certificate of Incorporation and Constitution with respect to all directors, other than the Chief Executive Officer, would apply only to Industry Directors.<sup>29</sup> The Exchange also represents that currently, all of ISE's Non-Industry Directors face term limits that would result in a total turn-over of such directors over a two-year period. The Exchange believes that removing term limits for Non-Industry Directors will allow the ISE Board to

(instead of the Chief Executive Officer) to appoint and remove officers (see Sections 4.2 and 4.3 of the Amended Constitution); the consolidation of the positions of Chief Executive Officer and President (see Section 4.1 of the Amended Constitution); and the prohibition on ownership of shares of Class B Common Stock by officers of the Exchange (see Section 4.5 of the Amended Constitution).

<sup>28</sup> See Amended Certificate, Article Fourth.

<sup>29</sup> See Amended Certificate, Article Fifth, and Amended Constitution, Section 3.2.

continue to function with experienced Non-Industry Directors, thereby facilitating a smooth transition to a public company structure. Once it becomes a public company, the Exchange represents that it will address term limits for Non-Industry Directors through amendments to its Corporate Governance Principles.<sup>30</sup>

#### 3. Ownership and Voting Limitations With Respect to the Exchange's Capital Stock<sup>31</sup>

a. *Ownership Limitations.* Under the proposed Amended Certificate, no "Person"<sup>32</sup> either alone or together with its "Related Persons"<sup>33</sup> would be permitted to own, directly or indirectly, of record or beneficially,<sup>34</sup> shares of

<sup>30</sup> Because the ISE Board believes it is important that following the Exchange's IPO there be a smooth transition from the Non-Industry Directors serving at the time of the IPO to their successors, the ISE Board has adopted Corporate Governance Principles providing that it may be appropriate for up to four of the eight original Non-Industry Directors to serve one additional term. This would result in a transition to new Non-Industry Directors over a four-year period, rather than a two-year period. The ISE Corporate Governance Committee will determine whether, and how, to provide for this phased transition.

<sup>31</sup> Currently, with the exception of certain exemptions for Founders (as defined in the Constitution), no holder of Class A Common Stock, together with any affiliate (as defined in the Constitution), shall vote or give any proxy in relation to a vote with respect to any shares owned in excess of 20 percent of the Class A Common Stock, and no holder of Class B Common Stock, together with any affiliate (as defined in the Constitution) may own more than 20 percent of Series B-1 Stock or Series B-2 Stock. In addition, no Member (as defined in the Constitution), together with any affiliate (as defined in the Constitution), may be approved to exercise trading rights associated with more than 20 percent of Series B-1 Stock or Series B-2 Stock (the "member trading concentration limit"). Certificate of Incorporation, Article Fourth, Subdivision II(a)(iv) and Constitution, Article XIV. See also Securities Exchange Act Release No. 45803, *supra* note 9. As discussed herein, the Exchange proposes to amend ISE Rule 303 to provide for the member concentration limit that is currently provided for in the Constitution.

<sup>32</sup> "Person" as defined in Article Fourth, Subdivision III of the Amended Certificate means any "individual, partnership (general or limited), joint stock company, corporation, limited liability company, trust or unincorporated organization or any governmental entity or agency or political subdivision thereof."

<sup>33</sup> "Related Person" as defined in Article Fourth, Subdivision III of the Amended Certificate means "(1) with respect to any Person, all 'affiliates' and 'associates' of such Person (as such terms are defined in Rule 12b-2 under the Act); (2) with respect to any Person constituting a Member, any broker or dealer with which such Member is associated; and (3) any two or more Persons that have any agreement, arrangement or understanding (whether or not in writing) to act together for the purpose of acquiring, voting, holding or disposing of shares of the capital stock of the [Exchange]."

<sup>34</sup> Beneficial ownership (and derivative or similar words) as defined in Article Fourth, Subdivision III of the Amended Certificate, would have the meaning set forth in Regulation 13D-G under the

capital stock (whether common or preferred stock) of the Exchange (1) constituting more than 40 percent of the then outstanding shares of any class or series of capital stock (the "40 percent ownership limitation"); or (2) constituting more than 20 percent of the then outstanding shares of any class or series of capital stock if such holder also is a member of the Exchange (that is, a Primary Market Maker, Competitive Market Maker or Electronic Access Member) (the "20 percent member ownership limitation").<sup>35</sup>

Furthermore, pursuant to the Amended Certificate, any Person, alone or together with its Related Persons, who owns more than five percent of the then outstanding shares of any class or series of the Exchange's capital stock will be required to provide certain information to the Board and will have an ongoing obligation to update such information.<sup>36</sup> The Exchange believes these provisions will enable it to obtain information necessary to determine whether there has been a violation of the voting or ownership limitations described herein.

The Exchange represents that it would apply standard corrective procedures used by public companies with similar

Act. The Exchange believes that use of this existing Commission definition will aid it in verifying the ownership of its capital stock by monitoring filings on Schedules 13D and 13G by its stockholders.

<sup>35</sup> See Amended Certificate, Article Fourth, Subdivisions III(a)(i) and (a)(ii).

<sup>36</sup> Article Fourth, Subdivision III(a)(iii) of the Amended Certificate requires that any Person, either alone or together with its Related Persons, that at any time owns 5 percent or more of the then outstanding shares of any class or series of capital stock of ISE, that has the right by its terms to vote in the election of members of the ISE Board, must, immediately upon so owning 5 percent or more, give the ISE Board written notice of such ownership stating: (1) Such Person's full legal name; (2) such Person's title or status and the date on which such title or status was acquired; (3) such Person's approximate ownership interest in the Exchange; and (4) whether such Person has the power, directly or indirectly, to direct the management or policies of the Exchange, whether through ownership of securities, by contract or otherwise. Each such Person must notify the ISE Board of any changes in ownership except when such change is an increase or decrease of less than 1 percent in the ownership percentage so reported (such increase or decrease to be measured cumulatively from the amount shown on the last such report) unless any increase or decrease of less than 1 percent results in such Person so owning more or less than 20 percent or more than 40 percent of the shares of any class or series of capital stock then outstanding (at a time when such Person so owned less than such percentages), as the case may be. The Exchange represents that it also will consider, among other things, any filings made with the Commission under Section 13(d) and Section 13(g) of the Act by such Person and its Related Persons and will aggregate all shares owned or voted by such Person and its Related Persons deemed to be beneficially owned by them. For information on ISE's current principal stockholders, see also the Registration Statement, "Principal and Selling Stockholders."

ownership limits if any Person, alone or together with its Related Persons, purports to sell, transfer, assign or pledge any shares of capital stock in the Exchange in violation of the ownership limits. Specifically, pursuant to the Amended Certificate, any such sale, transfer, assignment or pledge would be void, and that number of shares in excess of the ownership limitation would be deemed to have been transferred to the Exchange, as special trustee of a charitable trust, for the exclusive benefit of a charitable beneficiary to be determined by the Exchange.<sup>37</sup> These corrective procedures also would apply if there is any other event causing any holder of capital stock to exceed the ownership limits, such as a repurchase of shares by the Exchange.<sup>38</sup> The automatic transfer would be deemed to be effective as of the close of business on the business day prior to the date of the violative transfer or other event.

The special trustee of the trust would be required to sell the excess shares to a person whose ownership of shares is not expected to violate the ownership limitations, subject to the right of the Exchange to repurchase those shares.<sup>39</sup> The net proceeds of the sale would be distributed first to the original prohibited transferee or holder, who would receive the lesser of (1) the price per share received by the Exchange from the transfer of the excess shares, (2) the price per share the prohibited transferee or holder paid for the shares in the violative transfer, or (3) if the prohibited transferee or holder did not give value for such excess shares, a price per share equal to the market price for the excess shares on the date of the purported transfer or other event that resulted in the excess shares, except that in the case of a prohibited holder holding excess shares solely as the result of an action or event by the Exchange (such as an action resulting in a reduction in the number of outstanding shares), such prohibited holder would receive the greater of (1) or (3) above for the excess shares. After such distribution, any proceeds in excess of the amount payable to the prohibited transferee or holder would be payable to the charitable beneficiary. Prior to the sale, the special trustee would be entitled to

<sup>37</sup> See Article Fourth, Subdivision III(c) of the Amended Certificate. The Exchange may also determine to appoint as special trustee an entity unaffiliated with the Exchange and any Person or its Related Persons owning excess shares. See Article Fourth, Subdivision III(c)(ii) of the Amended Certificate.

<sup>38</sup> Any holders owning excess shares as a result of any event other than a sale, transfer, assignment or pledge would cease to have rights in such shares.

<sup>39</sup> See *infra* note 41 and accompanying text.

receive, in trust for the beneficiary, all dividends and other distributions paid by the Exchange with respect to the excess shares, and also would be entitled to exercise all voting rights with respect to the excess shares.<sup>40</sup>

In addition, excess shares (including any shares deemed to be excess shares by reason of a reduction in outstanding shares caused by a purchase of excess shares by the Exchange) would be deemed to have been offered for sale to the Exchange.<sup>41</sup> The Exchange shall have the right to accept such offer until the special trustee has sold the shares held in the charitable trust.<sup>42</sup> If the Exchange accepts such offer, it would determine the additional number of shares (if any) that become excess shares by reason of the reduction in outstanding shares caused by the Exchange's purchase of excess shares (whether any Person, either alone or together with its Related Persons, holds such excess shares in connection with a purported transfer or is deemed to hold such excess shares as a result of the Exchange's purchase of excess shares) and take all action reasonably necessary to ensure that such additional excess shares are added to the initial number of excess shares subject to the Exchange's corrective procedures.<sup>43</sup>

<sup>40</sup> Any excess shares held by the special trustee would be entitled to be voted by the special trustee and would be deemed outstanding for purposes of determining a quorum or minimum vote required for the transaction of any business at any stockholders' meeting. See Article Fourth, Subdivision III(c)(v) of the Amended Certificate.

<sup>41</sup> The excess shares would be deemed to be offered to the Exchange at a price per share equal to the lesser of (1) the price per share the purported transferee or holder paid for the shares in the purported transfer or other event that resulted in excess shares (or in the case of an event not involving any payment, the market price at the time of the transfer or other event) and (2) the market price of the shares on the date the Exchange accepts such offer. The Exchange may accept the offer in whole or in part.

<sup>42</sup> See Article Fourth, Subdivision III(c)(vi) of the Amended Certificate.

<sup>43</sup> The Exchange believes that this mechanism will prevent repeated violations (*i.e.*, an endless loop) of the ownership provisions in connection with repurchases by the Exchange (both generally and with respect to excess shares). In practice, the Exchange represents that it would structure repurchases, if any, in a manner designed not to trigger any new violations of the ownership restrictions set forth in Article Fourth, Subdivision III, or if triggered, to include such new violations in its repurchase. For example, if there were 100 shares of Class A Common Stock outstanding and two members of the Exchange (Member A and Member B) each currently owned 20% of the outstanding shares of Class A Common Stock, and Member A purchased 5 shares of Class A Common Stock (increasing his ownership to 25%), the Exchange could either (a) repurchase the 5 shares from Member A and permit the special trustee to sell one share from Member A and one share from Member B to third parties or (b) repurchase 9 shares of Class A Common Stock from Member A and 3 shares of Class A Common Stock from Member B,

As applied to the current outstanding capital stock of the Exchange, the 40 percent ownership limitation would apply to any holder of Class A Common Stock, other than an Exchange member. The 20 percent member ownership limitation would apply to any member, and would limit to that amount such holder's ownership of each of the Class A Common Stock and each Series of Class B Common Stock. The Exchange represents that currently no Person, either alone or together with its Related Persons, owns more than 40 percent of the outstanding shares of Class A Common Stock, and no member, either alone or together with its Related Persons, owns more than 20 percent of the outstanding shares of Class A Common Stock or any series of Class B Common Stock.<sup>44</sup>

b. *Voting Limitations.* The proposed rule change would prohibit any Person, either alone or together with its Related Persons, from voting, or causing the voting of, shares of capital stock of the Exchange (or giving a consent or proxy with respect to shares) representing more than 20 percent of the voting power of any class or series of capital stock (the "20 percent voting limitation").<sup>45</sup> In the event that a stockholder purports to vote, grant any proxy or enter into any other agreement for the voting of shares that would violate the 20 percent voting limitation, such vote, proxy or agreement would not be honored by the Exchange to the extent that the 20 percent voting limitation provision would be violated. The 20 percent voting limitation would not apply to any solicitation of any revocable proxy from any stockholder of the Exchange by the Exchange or by any

all of which would be deemed excess shares pursuant to the mechanism described above.

<sup>44</sup> See Amendment No. 2, *supra* note 4.

<sup>45</sup> The 20 percent voting limitation also would prohibit any Person, either alone or together with its Related Persons, from entering into any agreement, plan or other arrangement with another Person that would result in the shares of any class or series of capital stock that are subject to such agreement, plan or arrangement not being voted on any matter or matters where the effect of such agreement, plan or other arrangement would be to enable any Person to vote, possess the right to vote or cause the voting of shares of any class or series of capital stock that would, as a result thereof, represent more than 20 percent of any class or series of capital stock available to be voted.

The Amended Certificate and the Amended Constitution clarify that only those shares entitled to vote would be counted for purposes of determining a quorum or a minimum vote required for the transaction of any business at any stockholders' meeting, including, without limitation, when specified business is to be voted on by a class or a series voting as a class. See Article Fourth, Subdivision III(b)(iii) of the Amended Certificate and Section 2.4 of the Amended Constitution. See also Amendment No. 2, *supra* note 4.

stockholder of the Exchange pursuant to Regulation 14A under the Act.<sup>46</sup>

c. *Board Notice Regarding Certain Limitations.* The proposed rule change would impose certain requirements on Persons to give notice of events regarding ownership that would exceed the proposed ownership or voting threshold. Specifically, any Person intending to exceed these ownership or voting limitations must provide the ISE Board with written notice of the fact at least 45 days (or such shorter period to which the Board expressly consents) prior to either the proposed acquisition of shares or the proposed exercise of voting rights, as the case may be.<sup>47</sup>

d. *Board Waiver of Certain Limitations.* The ISE Board may adopt a resolution specifying that it has determined that the 40 percent ownership limitation or the 20 percent voting limitation or both should be waived if it finds that such waiver (1) will not impair the ability of the Exchange to carry out its functions and responsibilities as an "exchange" under the Act; (2) is otherwise in the best interests of the Exchange and its stockholders; (3) will not impair the ability of the Commission to enforce the Act; and (4) will apply to a Person and its Related Persons who are not subject to any applicable "statutory disqualification" (within the meaning of Section 3(a)(39) of the Act). In the event of such a finding, the waiver would take the form of an amendment to the Constitution, which would not be effective until approved by the Commission. The Board may not waive the 20 percent member ownership limitation.<sup>48</sup>

e. *Elimination of Founders Exemption.* The Amended Certificate also eliminates the "founders exemption" that permitted the original founders of the Exchange to own shares of Class A Common Stock and Class B Common Stock in excess of the stated limits for a certain period of time.<sup>49</sup> The Exchange represents that because all of the founders have fallen below the ownership thresholds in place, the exemption is no longer necessary.

<sup>46</sup> See Amended Certificate, Article Fourth, Subdivision III(b).

<sup>47</sup> See Amended Certificate, Article Fourth, Subdivisions III(a)(i)(E) and (b)(i).

<sup>48</sup> See Amended Certificate, Article Fourth, Subdivisions III(a)(i)(B) and (b)(i).

<sup>49</sup> The founders exemption, which applied to persons or entities that purchased LLC memberships directly from the Exchange on or prior to August 1, 1998 and extended to May 26, 2010, was approved by the Commission in connection with the Exchange's demutualization in 2002. See *supra* note 9.

#### 4. Exchange Act Obligations

The proposed rule change would provide that the ISE Board shall, in managing the affairs and business of the Exchange, consider requirements applicable to its registration and operation as a national securities exchange under the Act, including without limitation, the requirements that (a) the rules of the Exchange be designed to protect investors and the public interest, and (b) the Exchange be so organized and have the capacity to carry out the purposes of the Act and (subject to such exceptions as are set forth in the Act or the rules and regulations thereunder) to enforce compliance by its members and persons associated with its members with the provisions of the Act, the rules and regulations thereunder, and the rules of the Exchange. These provisions in the Amended Certificate shall not be construed to create the basis for any cause of action against any director, and no director shall be liable, by virtue of these provisions, for such director's consideration or failure to consider the matters referred to therein.<sup>50</sup>

#### 5. Board Committees

The proposed rule change would include provisions relating to specific Board committees in connection with the contemplated listing of the Exchange on a national securities exchange or national securities association following its IPO. In particular, the Exchange proposes to add the Corporate Governance Committee and the Compensation Committee to its list of specifically designated ISE Board committees in the Amended Constitution, and require that each of the Finance & Audit, Corporate Governance and Compensation Committees be governed by charters.<sup>51</sup>

#### 6. Certain Anti-Takeover Provisions

The Exchange proposes that the Amended Certificate and the Amended Constitution include certain anti-takeover provisions for protection against certain types of coercive corporate takeover practices and inadequate takeover bids. The proposed provisions relate to special meetings of stockholders and the required stockholder vote with respect to certain actions. In view of the limitations on ownership and voting described above,

<sup>50</sup> See Amended Certificate, Article Twelfth.

<sup>51</sup> See Amended Constitution, Sections 5.4, 5.5 and 5.6. The Exchange represents that it currently has a Corporate Governance and Compensation Committee, designated by the ISE Board pursuant to its authority under Section 5.1 of the Constitution; the Amended Constitution will specifically provide for these committees.

the provisions proposed do not include a "poison pill" arrangement. The Exchange represents that the ISE Board does, however, maintain the authority under its current organizational documents to adopt such an arrangement with Commission approval.

a. *Elimination of a Stockholder's Right to Call a Special Meeting.* The Exchange proposes to deny the Exchange's stockholders the right to call a special meeting of stockholders, and provide that only the Chairman of the Board or a majority of the Board may call a special meeting of the stockholders.<sup>52</sup>

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

Following the IPO, pursuant to the Exchange's Corporate Governance Committee charter and Section 3.10(b) of the Constitution, the Corporate Governance Committee would nominate for election to the Board a slate of Non-Industry Directors pursuant to Section 2.7(a) and (b).<sup>53</sup> These procedures also provide that notice of stockholder nominations for election of Non-Industry Directors and stockholder proposals must be given in writing to the Secretary of the Exchange prior to the meeting at which the action is to be taken.<sup>54</sup> Generally, such notice would have to be received at the principal executive offices of the Exchange not fewer than 60 days nor more than 90 days prior to the meeting. Any such notice must comply with certain additional informational and descriptive requirements set out in the Amended

<sup>52</sup> See Amended Certificate, Article Eighth and Amended Constitution, Section 2.2.

<sup>53</sup> Class A stockholders also would be able to nominate Non-Industry Directors pursuant to Sections 2.7 and 3.10(b) of the Constitution.

<sup>54</sup> With the institution of Section 2.7 of the Amended Constitution, Non-Industry Director nominations by Class A stockholders will likely be required to be made in advance of the selection or announcement of a slate of Non-Industry Director candidates by the Corporate Governance Committee. Currently, Non-Industry Director nominations by Class A stockholders must be made in advance of the stockholders' meeting, but generally after the Corporate Governance Committee announces its slate.

Constitution.<sup>55</sup> Additionally, stockholders shall comply with all applicable requirements of the Act and the rules and regulations thereunder with respect to any proposals submitted pursuant to the advance notice procedures.<sup>56</sup>

The requirement in Section 2.7(c) of the Amended Constitution, which states that only persons who are nominated in accordance with the procedures set forth in Section 2.7 shall be eligible to serve as directors, will not apply to nominations of Industry Director nominees for election to the Board. Such Industry Directors are, instead, nominated by the Exchange's Nominating Committee (which is not a committee of the Board) or stockholders pursuant to Sections 3.10(a) and 5.3(c) of the Constitution.

*c. Increase in Required Vote for Certain Stockholder Actions.* In addition to other currently required items,<sup>57</sup> the Amended Certificate would require a two-thirds vote of stockholders to amend, repeal or adopt any provisions inconsistent with (1) the limitations on ownership and voting of capital stock contained in the Amended Certificate, as described above in Section II.B.3, (2) the provision in the Amended Certificate providing the Board with the authority to create and issue rights

<sup>55</sup> In particular, the notice must set forth (1) as to each person whom the stockholder proposes to nominate for election or reelection as a director all information relating to such person that is required to be disclosed in solicitations of proxies for election of directors, or is otherwise required, in each case pursuant to Regulation 14A under the Act, including such person's written consent to being named in the proxy statement as a nominee and to serving as a director if elected and a statement that such nominee complies with the requirements set forth in the Amended Certificate; (2) as to any other business that the stockholder proposes to bring before the meeting, a brief description of the business desired to be brought before the meeting, the reasons for conducting such business at the meeting and any material interest in such business of such stockholder and the beneficial owner, if any, on whose behalf the proposal is made; and (3) as to the stockholder giving the notice and the beneficial owner, if any, on whose behalf the nomination or proposal is made (i) the name and address of such stockholder, as they appear on the Corporation's books, and of such beneficial owner and (ii) the class and number of shares of the Corporation which are owned beneficially and of record by such stockholder and such beneficial owner. See Amended Constitution, Section 2.7.

<sup>56</sup> See Amended Constitution, Section 2.7. Previously, Section 2.7 of the Constitution addressed stockholder record dates; that matter will now be addressed in Section 7.4 of the Amended Constitution.

<sup>57</sup> Pursuant to the Certificate of Incorporation, Article Seventh (b), the affirmative vote of the holders of at least two-thirds of the voting power of the then outstanding shares of Class A Common Stock shall be required to amend, repeal or adopt Article Seventh of the Certificate of Incorporation or Sections 2.2, 2.4, 2.5, 2.9, 3.2, 3.3, 3.5 or Article XI of the Constitution.

under a rights plan, and (3) the advance notice provision contained in the proposed Amended Constitution as described above in Section II.B.6.b.<sup>58</sup>

#### 7. Reduction in Votes Required To Approve Amendments to the Amended Constitution

The Exchange proposes that the current vote required to approve amendments to the Constitution be reduced from two-thirds of the voting power of each class of capital stock of ISE entitled to vote on such amendment to a majority vote of the voting power of each class or series of stock entitled to vote, voting together as a single class, in order to amend certain provisions of the Amended Constitution that are not subject to a required two-thirds vote under the Amended Certificate.<sup>59</sup> Such amendments to the current Constitution may be accomplished by a two-thirds vote of the stockholders or by action of the Board. The two-thirds vote requirement for an amendment to the current Constitution was deemed appropriate for a private securities exchange owned primarily by its members, in order to assure substantial agreement as to changes in significant aspects of corporate governance. However, the Exchange believes that the continuation of such a high vote requirement, in the context of a publicly traded company with a widely diverse stockholder base and the likelihood of lower voting participation, makes it unduly difficult to effect any necessary changes by stockholder vote to these corporate governance provisions in the future.

#### 8. Confidential Information and Books and Records

Pursuant to the Amended Certificate, all confidential information pertaining to the self-regulatory function of the Exchange (including but not limited to disciplinary matters, trading data, trading practices and audit information) contained in the books and records of the Exchange shall: (1) Not be made available to any Persons other than to those officers, directors, employees and agents of the Exchange that have a reasonable need to know the contents thereof and to the Commission; and (2) be retained in confidence by the Exchange and the officers, directors, employees and agents of the Exchange; and (3) not be used for any commercial purposes.<sup>60</sup> In addition, the ISE's books

and records shall be maintained within the United States.<sup>61</sup>

#### C. Amendment to ISE Rule 303

The Exchange proposes to amend ISE Rule 303(b) to include the member trading concentration limit currently included in the Constitution. Currently, pursuant to Section 14.1(b) of the Constitution, no Member (as defined in the Constitution), together with any affiliate (as defined in the Constitution), may be approved to exercise trading rights associated with more than 20 percent of Series B-1 Stock or Series B-2 Stock (the "member trading concentration limit"). Section 14.1(b) also permits the Exchange to establish further limitations relating to its approval of a Member's ability to effect transaction on or through the facilities of ISE. Article XIV of the Constitution, including Section 14.1(b), is being deleted from the Amended Constitution. Rule 303 currently provides for a stricter member trading concentration limit than 20% but permits the ISE Board to waive such member trading concentration limit for good cause shown.<sup>62</sup> The Exchange proposes to amend Rule 303(b) to include the member trading concentration limit currently provided for in Section 14.1(b) and to state that the Board shall not waive the Exchange's member trading concentration limit if such a waiver would result in the applicant or approved Member (as defined in the Constitution) (together with any of its affiliates) being approved to exercise the trading privileges associated with more than 20% of the outstanding Primary Market Maker memberships (which memberships are associated with the shares of Series B-1 Stock as set forth in Article XIII of the Amended Certificate) or more than 20% of the outstanding Competitive Market Maker memberships (which memberships are associated with the shares of Series B-2 Stock as set forth in Article XIII of the Amended Constitution). Rule 303(b), as amended, will not permit the Exchange to establish further limitations, as the current Constitution does. ISE represents that the amendment to Rule 303(b) will enable the Exchange and the Commission to protect the integrity of the Exchange's and the Commission's regulatory oversight responsibilities in much the same way as the proposed ownership and voting limitations discussed above will.<sup>63</sup>

<sup>58</sup> See Amended Certificate, Article Seventh.

<sup>59</sup> See Amended Certificate, Article Seventh and Amended Constitution, Section 11.1.

<sup>60</sup> See Amended Certificate, Article Thirteenth.

<sup>61</sup> See Amended Constitution, Section 1.3.

<sup>62</sup> See *infra* Section IV.D for further discussion of the current requirements of ISE Rule 303.

<sup>63</sup> See Amendment No. 2, *supra* note 4.

### III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether this submission 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](mailto:rule-comments@sec.gov). Please include File Number SR-ISE-2004-29 on the subject line.

#### *Paper Comments*

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

All submissions should refer to File Number SR-ISE-2004-29. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the ISE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to Amendment No. 2 of File Number SR-ISE-2004-29 and should be submitted on or before February 10, 2005.

### IV. Discussion

The Commission has considered the ISE's proposed rule change, as amended, and finds that the proposal is consistent with the Act and the rules and regulations thereunder applicable to

a national securities exchange.<sup>64</sup> In particular, the Commission finds that the proposal is consistent with Section 6(b)(1) of the Act,<sup>65</sup> which requires a national securities exchange to be so organized and have the capacity to be able to carry out the purposes of the Act and to enforce compliance by its members and persons associated with its members with the provisions of the Act, the rules or regulations thereunder, and the rules of the Exchange. In addition, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>66</sup> which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade; to facilitate transactions in securities; to remove impediments to and perfect the mechanisms of a free and open market and a national market system; and, in general, to protect investors and the public interest.

The Commission discusses below significant aspects of the proposed rule change.

#### *A. Exchange Governance Structure*

The proposed rule change would clarify in the Amended Constitution that the ISE Board, in addition to an Executive Committee, has a Corporate Governance Committee, Finance & Audit Committee<sup>67</sup> and Compensation Committee. The Exchange also has a Nominating Committee which is not a committee of the ISE Board. Pursuant to the Amended Constitution, each of the Finance & Audit and Compensation Committees will be comprised of three (3) and no more than five (5) Non-Industry Directors. The Corporate Governance Committee will be comprised of three (3) and no more than eight (8) Non-Industry Directors. The ISE Board will adopt a charter setting forth the responsibilities of each of these committees.<sup>68</sup> The Commission notes that information about the existence of the Corporate Governance and Compensation Committee was previously not widely available or specified in the Constitution. Thus, the proposed amendments would serve to increase transparency with respect to these key committees and, thus, serve to improve their accountability to the

<sup>64</sup> In approving the proposed rule change, the Commission has considered its impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>65</sup> 15 U.S.C. 78f(b)(1).

<sup>66</sup> 15 U.S.C. 78f(b)(5).

<sup>67</sup> The Finance & Audit Committee is referred to as the Audit Committee under the current Constitution. See Section 5.4 of the Constitution.

<sup>68</sup> See Sections 5.4, 5.5 and 5.6 of the Amended Constitution.

benefit of the Exchange and the investing public. The Exchange also has proposed certain other changes to facilitate its conversion to a public company.<sup>69</sup>

The Commission generally believes ISE's proposed changes should serve to strengthen and improve the Exchange's governance structure and are consistent with the Act. The Commission notes, however, that it is in the process of reviewing a range of governance issues relating to self-regulatory organizations ("SROs"), including possible steps to strengthen the framework for the governance of SROs and ways to improve the transparency of the governance procedures of all SROs and has proposed rules in furtherance of this goal.<sup>70</sup> Depending upon the results of the proposed rules, the ISE may be required to make further changes to further strengthen its governance structure. The Commission also believes that the ISE Board should continue to monitor and evaluate the Exchange's governance structure and processes on an ongoing basis, and propose further changes as appropriate.

#### *B. Changes in Control of the ISE*

The proposed Amended Certificate would impose limitations on direct and indirect changes in control of the ISE through voting and ownership limitations placed on ISE's capital stock (whether common stock or preferred stock) and allow the ISE Board to monitor potential changes in control through a notification requirement, once a threshold percentage of ownership of capital stock is reached.<sup>71</sup> The Commission believes that the limitations on direct and indirect changes in control of the ISE, which are designed to prevent any shareholder (or shareholders acting together) from exercising undue control over the operation of the exchange and to help ensure that the ISE and the Commission are able to carry out their regulatory

<sup>69</sup> See *supra* Section II.B for a discussion of the other proposed changes.

<sup>70</sup> See Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004).

<sup>71</sup> The Amended Certificate requires that any Person, either alone or together with its Related Persons, who at any time owns five percent (5%) or more of the then outstanding shares of the capital stock and who has the right to vote in the election of the ISE Board of the Exchange shall, immediately upon so owning five percent (5%) or more of the then outstanding shares of such stock give the ISE Board written notice of such ownership and update the notice promptly after an ownership change of a specified percentage. See Article Fourth, Subdivision III(a)(iii)-(iv) of the Amended Certificate.

responsibilities, are consistent with the Act.<sup>72</sup>

Specifically, the proposed Amended Certificate provides that, unless approved by the ISE Board and effective under Section 19(b) of the Act,<sup>73</sup> no person, either alone or together with its related persons, has any right to vote, or to give any consent or proxy with respect to, more than 20% of the then outstanding shares of any class or series of capital stock of ISE.<sup>74</sup> Moreover, no person, either alone or together with its related persons, unless approved by the ISE Board and effective under Section 19(b) of the Act,<sup>75</sup> may own, of record or beneficially, whether directly or indirectly, more than 40% of the then outstanding shares of any class or series of capital stock of ISE.<sup>76</sup> To the extent that such person, or its related person, purports to acquire or own more than 40% of the then outstanding shares of any class or series of capital stock of ISE, the person, and its related persons, will not have any rights incident to ownership of shares in excess of the 40% limit.<sup>77</sup>

The ISE Board will only be able to waive the 20% voting and 40% ownership limitations if it adopts an amendment to ISE's Constitution after making certain findings that doing so would not impair the ability of ISE and the Commission to carry out their respective regulatory obligations and is otherwise in the best interests of the Exchange. The ISE Board, however, will not be permitted to approve a member or person subject to a statutory disqualification to exceed the limits.<sup>78</sup> The resolution would then be filed with the Commission as a proposed rule change under Rule 19b-4 of the Act,<sup>79</sup> and the resolution would not become

<sup>72</sup> The Commission notes that it is in the process of reviewing issues relating to new ownership structures of SROs, and has proposed rules relating to the ownership of SROs, including imposing limitations on member ownership of an SRO or facility of an SRO. See Securities Exchange Act Release No. 50699, *supra* note 70.

<sup>73</sup> 15 U.S.C. 78s(b).

<sup>74</sup> See Article Fourth, Subdivision III(b) of the Amended Certificate. The terms "person" and "related persons" are defined in Article Fourth, Subdivision III(a) of the Amended Certificate, and are described in Section II.B.3.a above.

<sup>75</sup> 15 U.S.C. 78s(b).

<sup>76</sup> See Article Fourth, Subdivision III(a) of the Amended Certificate.

<sup>77</sup> See Article Fourth, Subdivision III(c) of the Amended Certificate. See also *supra* Section II.B.3.a.

<sup>78</sup> In making such determinations, the ISE Board may impose any conditions and restrictions on such person and its related persons owning any shares of stock of ISE entitled to vote on any matter as the ISE Board in its sole discretion deems necessary, appropriate or desirable. See Article Fourth, Subdivision III(a)(i) and (b)(i) of the Amended Certificate.

<sup>79</sup> 17 CFR 240.19b-4.

effective until the proposed rule change becomes effective thereunder.<sup>80</sup> The proposed rule change would present the Commission with an opportunity to determine what additional measures, if any, might be necessary to provide sufficient regulatory jurisdiction over the proposed controlling persons.

Furthermore, the Amended Certificate also contains provisions designed to provide a disincentive for persons to exceed these limitations without the requisite prior approval.<sup>81</sup> Specifically, pursuant to the Amended Certificate, shares in excess of the ownership limitations would be deemed to have been transferred to the Exchange, as special trustee of a charitable trust, for the exclusive benefit of a charitable beneficiary to be determined by the Exchange.<sup>82</sup> The purchaser would cease to have voting and economic rights in the excess shares, other than the right to receive proceeds from the sale of such shares by the trustee.<sup>83</sup> In addition, if votes were cast in excess of the 20% voting limitation, ISE would be required to disregard such votes cast in excess of the 20% voting limitation.<sup>84</sup>

The proposed Amended Certificate also provides that no member of ISE, either alone or together with its related persons, will be allowed to own, of record or beneficially, whether directly or indirectly, more than 20% of the then outstanding shares of any class or series

<sup>80</sup> See Article Fourth, Subdivision III(a)(i) and (b)(i) of the Amended Certificate.

<sup>81</sup> See Article Fourth, Subdivision III(c) of the Amended Certificate.

<sup>82</sup> See Article Fourth, Subdivision III(c) of the Amended Certificate. These corrective procedures also would apply if there is any other event causing any holder of capital stock to exceed the ownership limits, such as a repurchase of shares by the Exchange. Any holders owning excess shares as a result of any event other than a sale, transfer, assignment or pledge would cease to have rights in such shares.

<sup>83</sup> See *supra* Section II.B.3.a for a more detailed description of how this process works.

<sup>84</sup> Article Fourth, Subdivision III(b)(ii) of the Amended Certificate provides that the 20% voting limitation provisions would not apply to (1) any solicitation of any revocable proxy from any stockholder of ISE by the ISE or by any stockholder of the ISE that is conducted pursuant to, and in accordance with, Regulation 14A promulgated pursuant to the Act. This provision is designed to ensure that the voting limitations will not restrict the exercise of proxy rights under Regulation 14A of the Act.

Article Fourth, Subdivision III(b)(iii) of the Amended Certificate provides that, to the fullest extent permitted by applicable law, shares of capital stock that are not entitled to be voted as a result of the 20% voting limitation shall not be deemed to be outstanding for the purposes of determining a quorum or a minimum vote required for the transaction of any business at any meeting of stockholders of ISE, including, without limitation, when specified business is to be voted on by a class or a series voting as a class.

of capital stock of ISE.<sup>85</sup> To the extent any member, or its related persons, purports to acquire or own more than 20% of the then outstanding shares of any class or series of capital stock of ISE, that member, and its related persons, will not have any rights incident to ownership of shares in excess of the 20% limit.<sup>86</sup> Furthermore, the Amended Certificate also contains provisions designed to provide a disincentive for persons to exceed this limitation.<sup>87</sup>

The Commission believes that the 20% ownership (and thus voting) limitation restriction on ISE members is reasonable and consistent with the Act. Members who trade on an exchange or through a facility of an exchange have traditionally had ownership interests in such exchange or facility. However, a member's interest could become so large as to cast doubt on whether the exchange can fairly and objectively exercise its self-regulatory responsibilities with respect to that member. An exchange may hesitate to diligently monitor and surveil the trading conduct of a member that is a controlling shareholder of the exchange, or to diligently enforce its rules and the federal securities laws with regard to conduct by such member that violates these provisions. The Commission believes that the proposed limitation would help mitigate the conflict of interest that could occur if a member were to control a significant stake in the Exchange, and are necessary and appropriate to help ensure that the Exchange can effectively carry out its statutory obligations under Section 6(b) of the Act.<sup>88</sup> The Commission notes that the Exchange represented that no member currently owns shares in excess of the 20% limitation.

The Amended Certificate of Incorporation also would require shareholders to report ownership interest of 5% or more to ISE. This provision would help the ISE Board more readily monitor ownership of its shares of stock in order to determine whether a person, either alone or with its related persons, would exceed these voting and ownership limitations.<sup>89</sup> The

<sup>85</sup> See Article Fourth, Subdivision III(a)(ii) of the Amended Certificate.

<sup>86</sup> See Article Fourth, Subdivision III(c) of the Amended Certificate.

<sup>87</sup> See *supra* notes 82-83 and accompanying text.

<sup>88</sup> 15 U.S.C. 78f(b).

<sup>89</sup> See *supra* note 71 and accompanying text. In addition, upon consummation of ISE's proposed IPO, the information required to be filed by shareholders pursuant to Regulations 13D and 13G will be available to ISE for purposes of determining whether any person, along or together with its related persons, has exceeded the voting and ownership limitations. The Commission also notes



Commission believes that this approach is consistent with the Act in that it allows the ISE to comply with the reporting requirements of Form 1, the application for (and amendments to application for) registration as a national securities exchange. Exhibit K of Form 1 requires any exchange that is a corporation or partnership to list any persons that have an ownership interest of five percent (5%) or more in the exchange, and Rule 6a-2(a)(2) under the Act requires an exchange to update its Form 1 within ten days after any action that renders inaccurate the information previously filed in Exhibit K.<sup>90</sup>

### C. Self-Regulatory Function of the ISE

After its IPO, the Exchange will continue to operate as a registered national stock exchange under Section 6 of the Act<sup>91</sup> and will maintain its current regulatory authority over members. All persons effecting transactions on or through the facilities of the Exchange will continue to be subject to the Exchange's rules. Certain provisions in the Amended Certificate and Amended Constitution are designed to facilitate the ability of ISE and the Commission to fulfill their regulatory obligations under the Act, and in particular under Sections 6(b)<sup>92</sup> and 19(g)<sup>93</sup> of the Act, with respect to the Exchange. Specifically, Article Twelfth of the Amended Certificate expressly requires the Directors, in managing the business and affairs of the ISE, to consider applicable requirements for registration as a national securities exchange under the Act, including the requirements that the rules of the ISE be designed to protect investors and the public interest and the ISE shall be so organized and have the capacity to carry out the purposes of the Act and (subject to exceptions set forth in the Act and rules and regulations thereunder) to enforce compliance with its members and persons associated with its members, with the provisions of the Act and the rules and regulations thereunder and with the ISE's Rules. In the Commission's view, this provision will serve to remind the Directors that they must consider the requirements of the Act when taking actions on behalf

that, upon completion of its IPO, the Exchange would be required to publicly disclose on a quarterly basis information regarding the number of outstanding shares of its Common Stock, so that persons with a stake in the Common Stock can determine whether they are reaching, or have reached, any of the thresholds that restrict that person's ability to vote or own shares. See 17 CFR 240.13a-13.

<sup>90</sup> 17 CFR 240.6a-2(a)(2).

<sup>91</sup> 15 U.S.C. 78f.

<sup>92</sup> 15 U.S.C. 78f(b).

<sup>93</sup> 15 U.S.C. 78s(g).

of the ISE and thus promote greater awareness and accountability on the part of the Directors.

Additionally, pursuant to the Amended Certificate, all confidential information pertaining to the self-regulatory function of the Exchange (including but not limited to disciplinary matters, trading data, trading practices and audit information) contained in the books and records of the Exchange shall: (1) Not be made available to any persons other than to those officers, directors, employees and agents of the Exchange that have a reasonable need to know the contents thereof; (2) be retained in confidence by the Exchange and the officers, directors, employees and agents of the Exchange; and (3) not be used for any commercial purposes.<sup>94</sup> In addition, the ISE's books and records shall be maintained within the United States.<sup>95</sup> The Commission believes that these provisions, which are designed to help maintain the independence and effectiveness of ISE's self-regulatory function, are appropriate and consistent with the Act.

The Exchange also will continue to interpret its rules to require that any revenues it receives from regulatory fees or regulatory penalties will be segregated and applied to fund the legal, regulatory and surveillance operations of the Exchange and will not be used to pay dividends to the holders of Class A Common Stock.<sup>96</sup> The Commission finds that the prohibition on the use of regulatory fines, fees or penalties to fund dividends is consistent with Section 6(b)(3) of the Act<sup>97</sup> because it will further advance ISE's ability to effectively comply with its statutory requirements by helping to ensure the regulatory authority of the Exchange is not improperly used.

### D. Membership Trading Concentration Limits

Currently, pursuant to ISE Rule 303, the ISE Board may not approve a member to operate more than one Primary Market Maker Membership or more than 10 Competitive Market Maker Memberships, unless the restriction is waived by the ISE Board for good cause. In addition, Section 14.1(b) of the Constitution requires that ISE may not approve an ISE member, together with

<sup>94</sup> See Amended Certificate, Article Thirteenth.

<sup>95</sup> See Amended Constitution, Section 1.3.

<sup>96</sup> The Exchange adopted this interpretation in connection with its demutualization in 2002. See *infra* note 9. The Commission also notes that the Exchange represents that the holders of the Class B Common Stock are not entitled to receive dividends. See Section II.A of Securities Exchange Act Release No. 50641, *supra* note 3.

<sup>97</sup> 15 U.S.C. 78f(b)(3).

any affiliate, to exercise the trading rights associated with more than twenty percent (20%) of ISE's Series B-1 Stock, nor more than twenty (20%) of ISE's Series B-2 Stock, and permits the Exchange to establish further limitations relating to the Exchange's approval of a member's ability to effect transactions on or through the facilities of the Exchange.

Pursuant to the proposed rule change, ISE would delete the 20% limitation from Section 14.1(b) of the Constitution, and would move it to Rule 303(b). Specifically, Rule 303(b) would not permit the ISE Board to waive the Primary Market Maker and Competitive Market Maker Membership concentration limits in Rule 303(b) if such waiver would result in an ISE member, together with any of its affiliates, being approved to exercise trading privileges associated with more than twenty percent (20%) of ISE's outstanding Primary Market Maker Memberships or more than twenty (20%) of ISE's outstanding Competitive Market Maker Memberships. The Commission believes this limitation on the ability to operate more than a certain percentage of memberships will serve to protect the integrity of the Exchange's regulatory oversight responsibilities by preventing the Exchange from becoming overly dependent on the business generated by any one member. Without such a provision, the Exchange may be reluctant to surveil and enforce its rules against such a member.

### V. Accelerated Approval of Amendment No. 2

Pursuant to Section 19(b)(2) of the Act,<sup>98</sup> the Commission may not approve any proposed rule change, or amendment thereto, prior to the thirtieth day after the date of publication of the notice of filing thereof, unless the Commission finds good cause for so finding. The Commission hereby finds good cause for approving Amendment No. 2 to the proposed rule change prior to the thirtieth day after publishing notice of the same in the **Federal Register** pursuant to Section 19(b)(2) of the Act.<sup>99</sup> Specifically, Amendment No. 2 provides technical, non-substantive amendments to correct typographical errors in the Amended Certificate and Amended Constitution, previously filed as part of the original proposed rule change,<sup>100</sup> and revises Section 2 of ISE's

<sup>98</sup> 15 U.S.C. 78s(b)(2).

<sup>99</sup> *Id.*

<sup>100</sup> The Commission notes that the Exchange also undertakes to present to the ISE Board and

Form 19b-4 (Procedures of the Self-Regulatory Organization) to reflect actions by the ISE Board and ISE's stockholders approving the final forms of the Amended Certificate and Amended Constitution. Amendment No. 2 also proposes changes to ISE Rule 303(b) and amended related portions of its Form 19b-4. Specifically, Amendment No. 2 amends ISE Rule 303(b) to incorporate the 20% limit on the trading privileges associated with Primary Market Maker and Competitive Market Maker Memberships that may be exercised by a member of ISE that currently is imposed by ISE's Constitution.<sup>101</sup> Because Amendment No. 2 moves the substance of an existing rule from ISE's Constitution to its Rules, the Commission believes that there is no new novel issue. Therefore, the Commission finds that good cause exists to accelerate approval of Amendment No. 2 to the proposed rule change, pursuant to Section 19(b)(2) of the Act.<sup>102</sup>

## VI. Conclusion

For the foregoing reasons, the Commission finds that the proposed

stockholders for approval the correction of certain typographical errors in the Amended Certificate at the next meetings of the ISE Board and stockholders at which other amendments to the Amended Certificate are also proposed, and will promptly file such corrections with the Commission pursuant to Section 19(b) of the Exchange Act. Specifically, the Exchange undertakes to propose to correct: Article Fourth, Subdivision III(a)(i) of the Amended Certificate to add a comma between the words "Person" and "either"; Article Fourth, Subdivision III(b)(i) of the Amended Certificate to delete a comma appearing between the words "ability of the Corporation" and "to carry out its functions"; and Article Fourth, Subdivision III(a)(i)(E) of the Amended Certificate to insert the word "would" between the words "or preferred that" and "result in such." The Exchange also undertakes to present to the ISE Board for approval the insertion of the word "a" between the words "the meeting until" and "quorum is present" in Section 5.5(b) of the Amended Constitution at the next meeting of the Board at which other amendments to the Amended Constitution are also proposed. See Amendment No. 2, *supra* note 4.

<sup>101</sup> See Section 14.1(b) of the Constitution. Pursuant to Section 14.1(b), ISE may not approve a Member of ISE, together with any affiliate, to exercise the trading rights associated with more than 20% of ISE's Series B-1 Stock, nor more than 20% of ISE's Series B-2 Stock, and may establish further limitations relating to ISE's approval of an ISE Member's ability to effect transactions executed on or through the facilities of the Exchange. The 20% limitation will be moved to Rule 303(b) of ISE's rules. Rule 303(b), as amended, would not permit the Exchange to establish further limitations, as the current Constitution does. The Exchange represents that it does not believe it will be necessary to establish further limitations. The language also reflects the current language of Rule 303(b) in that it refers to the exercise of trading privileges associated with a Primary Market Maker or Competitive Market Maker Membership, rather than the exercise of trading rights associated with series B-1 or B-2 stock.

<sup>102</sup> *Id.*

rule change, as amended, is consistent with the Act and rules and regulations thereunder applicable to a national securities exchange.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>103</sup> that the proposed rule change, including Amendment No. 2 thereto (SR-ISE-2004-29) be, and hereby is, approved, and that Amendment No. 2 thereto is approved on an accelerated basis. The proposed rule change shall be effective upon the closing of ISE's IPO as described herein.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>104</sup>

**J. Lynn Taylor,**

*Assistant Secretary.*

[FR Doc. E5-198 Filed 1-19-05; 8:45 am]

**BILLING CODE 8010-01-P**

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## SMALL BUSINESS ADMINISTRATION

### Public Federal Regulatory Enforcement Fairness Hearing; Region VI Regulatory Fairness Board

The Small Business Administration Region VI Regulatory Fairness Board and the SBA Office of the National Ombudsman will hold a Public Hearing on Monday, January 31, 2005 at 8:30 a.m. at Texas Tech University, Animal and Food Sciences Building, Room 101, located on the Southwest corner of Indiana Blvd. and Brownfield Highway, Lubbock, TX 79401, phone (806) 742-2513, to receive comments and testimony from small business owners, small government entities, and small non-profit organizations concerning regulatory enforcement and compliance actions taken by federal agencies.

Anyone wishing to attend or to make a presentation must contact Scotty Arnold in writing or by fax, in order to be put on the agenda. Scotty Arnold, Economic Development Specialist, SBA Lubbock District Office, Mahon Federal Building, 1205 Texas Ave., Room 408, Lubbock, TX 79401, phone (806) 472-7462 Ext. 102, fax (806) 472-7487, e-mail: [Scotty.arnold@sba.gov](mailto:Scotty.arnold@sba.gov).

For more information, see our Web site at <http://www.sba.gov/ombudsman>.

Dated: January 11, 2005.

**Peter Sorum,**

*Senior Advisor, Office of the National Ombudsman.*

[FR Doc. 05-1096 Filed 1-19-05; 8:45 am]

**BILLING CODE 8025-01-P**

<sup>103</sup> *Id.*

<sup>104</sup> 17 CFR 200.30-3(a)(12).

## DEPARTMENT OF STATE

[Public Notice 4957]

### Culturally Significant Objects Imported for Exhibition Determinations: "Defining Yongle: Imperial Art in Early Fifteenth-Century China"

**SUMMARY:** Notice is hereby given of the following determinations: Pursuant to the authority vested in me by the Act of October 19, 1965 (79 Stat. 985; 22 U.S.C. 2459), Executive Order 12047 of March 27, 1978, the Foreign Affairs Reform and Restructuring Act of 1998 (112 Stat. 2681, *et seq.*; 22 U.S.C. 6501 note, *et seq.*), Delegation of Authority No. 234 of October 1, 1999, Delegation of Authority No. 236 of October 19, 1999, as amended, and Delegation of Authority No. 257 of April 15, 2003 (68 FR 19875), I hereby determine that the objects to be included in the exhibition "Defining Yongle: Imperial Art in Early Fifteenth-Century China," imported from abroad for temporary exhibition within the United States, are of cultural significance. The objects are imported pursuant to a loan agreement with the foreign owner. I also determine that the exhibition or display of the exhibit objects at the Metropolitan Museum of Art, New York, New York, from on or about April 1, 2005, to on or about July 10, 2005, and at possible additional venues yet to be determined, is in the national interest. Public notice of these determinations is ordered to be published in the **Federal Register**.

**FOR FURTHER INFORMATION CONTACT:** For further information, including a list of the exhibit objects, contact Wolodymyr R. Sulzynsky, the Office of the Legal Adviser, Department of State, (telephone: 202/453-8050). The address is Department of State, SA-44, 301 4th Street, SW., Room 700, Washington, DC 20547-0001.

Dated: January 11, 2005.

**C. Miller Crouch,**

*Principal Deputy Assistant Secretary for Educational and Cultural Affairs, Department of State.*

[FR Doc. 05-1136 Filed 1-19-05; 8:45 am]

**BILLING CODE 4710-08-P**

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## DEPARTMENT OF TRANSPORTATION

### Office of the Secretary

#### Aviation Proceedings, Agreements Filed the Week Ending January 7, 2005

The following Agreements were filed with the Department of Transportation under the provisions of 49 U.S.C. 412 and 414. Answers may be filed within