

be submitted on or before October 23, 2006.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>20</sup>

Nancy M. Morris,

Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-54494; File No. SR-CHX-2006-23]

### Self-Regulatory Organizations; Chicago Stock Exchange, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 Thereto Regarding Amendments to the Exchange's Bylaws and Other Governance Changes

September 25, 2006.

#### I. Introduction

On June 22, 2006, the Chicago Stock Exchange, Inc. ("CHX" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend its bylaws and rules to make several governance changes. The CHX filed Amendment No. 1 to the proposed rule change on July 20, 2006. The proposed rule change, as amended, was published for comment in the *Federal Register* on August 3, 2006.<sup>3</sup> The Commission received no comments regarding the proposal. This order approves the proposed rule change, as amended.

#### II. Description of the Proposal

CHX proposes changes to its bylaws to reflect the terms of an agreement with four firms ("Investor Firms")<sup>4</sup> to invest in CHX Holdings, Inc., ("CHX Holdings").<sup>5</sup> CHX proposes to amend its

bylaws and rules to (1) require the Exchange's Board of Directors ("Board") to identify one position in each Board class as the "Subject to Petition (STP) Participant Director," with candidates for that position to be subject to a petition process involving the Exchange's participants; (2) change the composition of the Exchange's Nominating & Governance Committee to include two public directors and two STP Participant Directors; and (3) modify the Exchange's rules to confirm that each participant firm would need only one trading permit to conduct business on the Exchange.

#### Governance Changes

The CHX bylaws provide that the CHX Board currently consist of the Exchange's chief executive officer, seven public directors, and five participant directors.<sup>6</sup> The Board members are divided into three classes, with each class serving a three-year term. Under the terms of the agreements reached with the Investor Firms, the membership of the Board is to be reduced by one director, so that after the closing of the transactions, the Board would consist of the Exchange's chief executive officer, six public directors, and five participant directors. The agreements with the Investor Firms also require the Exchange to use its best efforts to place a representative of each of the Investor Firms on the CHX Board, filling four of the five participant director positions. The remaining participant director would not be affiliated with any of the Investor Firms.

#### STP Participant Directors

Under the Exchange's existing bylaws, the Nominating & Governance Committee ("Committee") identifies candidates to fill the Board positions that are up for election each year.<sup>7</sup> In identifying candidates for public

now referred to as Exchange "participants." For purposes of the Act, participants are considered to be members of the Exchange. See Rule 1.1 of Article I of the CHX Rules. See also *infra* note 6.

<sup>6</sup> See Article II, Section 2(c) of the Exchange's bylaws. A "public director" is a director who (i) is not a participant in the Exchange, or an officer, managing member, partner or employee of an entity that is a participant, (ii) is not an employee of the Exchange or any of its affiliates, (iii) is not a broker or dealer or an officer or employee of a broker or dealer, or (iv) does not have any other material business relationship with CHX Holdings or the Exchange (or with any of their affiliates) or with any broker or dealer. See Article II, Section 2(b) of the Exchange's bylaws. A "Participant Director" is a director who is a participant or an officer, managing member, or partner of an entity that is a participant. *Id.* An individual or entity is a participant in the Exchange if that individual or entity holds a trading permit issued by the Exchange. *Id.*

<sup>7</sup> See Article II, Section 3(b) of the Exchange's bylaws.

director positions, the Committee typically meets to discuss candidates and provides its slate of nominees to the Exchange's sole stockholder, CHX Holdings, for election.

The process for identifying candidates for participant director positions, however, is more detailed and includes both a requirement that the Committee hold two open meetings with Exchange participants and a petition process that allows participants to add names to the Committee's initial slate.<sup>8</sup> Under this process, no later than 60 days prior to the date announced for the Exchange's annual shareholder meeting, the Committee's initial nominees for participant director positions are reported to the Exchange's Secretary, who then must promptly announce the nominees to the Exchange's participants.<sup>9</sup> Participants may identify other candidates for one or more of these positions by delivering to the Exchange's Secretary, at least 35 days prior to the date announced for the annual meeting of shareholders, a written petition, signed by at least ten participants, identifying additional candidates.<sup>10</sup> If one or more valid petitions are submitted, the Exchange conducts an election to confirm the participants' selections of nominees for the participant director positions.<sup>11</sup>

Each participant has one vote with respect to each participant director position that is to be filled. The individuals having the largest number of votes are the final nominees, and the Nominating & Governance Committee must nominate these persons to fill the available positions.<sup>12</sup> This process is designed to provide Exchange participants with fair representation in the selection of Exchange directors.<sup>13</sup>

The Exchange proposes to amend its bylaws to require the Board to set aside one position in each Board class for an STP Participant Director, with the candidates for each of those positions to be subject to the petition process. The Exchange acknowledges that the proposal would reduce the number of participant directors whose elections are subject to this petition process, but maintains that it would still ensure that at least 20% of the Exchange's directors (on a Board of fifteen or fewer people)

<sup>8</sup> See Article II, Section 3(d) of the Exchange's bylaws.

<sup>9</sup> See *id.*

<sup>10</sup> See *id.*

<sup>11</sup> See *id.*

<sup>12</sup> See Article II, Section 3(b) and (e) of the Exchange's bylaws.

<sup>13</sup> See 15 U.S.C. 78f(b)(3) (requiring that the rules of an exchange assure a fair representation of its members in the selection of its directors and administration of its affairs).

<sup>20</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> Securities Exchange Act Release No. 54226 (July 27, 2006), 71 FR 44064 ("Notice").

<sup>4</sup> Each investment represents a minority equity stake in CHX Holdings consisting of shares of CHX Holdings Series A Preferred Stock.

<sup>5</sup> See Securities Exchange Act Release No. 51149 (Feb. 8, 2005), 70 FR 7531 (Feb. 14, 2005) (order approving Exchange's demutualization). As part of the demutualization, former CHX members received common stock in CHX Holdings and received CHX trading permits entitling them to maintain their access to the Exchange. In addition, other persons who satisfy the applicable requirements were granted the ability to obtain trading permits, regardless of whether they are shareholders in CHX Holdings. Persons who hold trading permits are

are selected in this manner.<sup>14</sup> In addition, by requiring that the Board identify one position in each of the three Board classes to be subject to the petition process, the proposal would allow participants an opportunity to select at least one participant director each year.

#### *Composition of the Nominating & Governance Committee*

The Exchange's Nominating & Governance Committee currently is composed of six Board members—three participant directors and three public directors.<sup>15</sup> The Exchange proposes to reduce its size so that it consists of two public directors and two STP Participant Directors.<sup>16</sup> Under the proposal, at least one participant director who is not affiliated with any of the four Investor Firms will serve on the Committee by requiring that one of the STP Participant Directors on the Committee not be a representative of any of the Investor Firms.

#### *Trading Permits*

Under the Exchange's existing rules, each participant firm or each person who is registered as a co-specialist, floor broker, or market maker for a participant firm must hold a valid trading permit.<sup>17</sup> The Exchange proposes to change this requirement so that each participant firm must hold a valid trading permit, but individuals who serve as co-specialists, floor brokers, and market makers for a firm are no longer subject to the requirement.<sup>18</sup> Persons who serve in these capacities would continue to be required to register with the Exchange.

### III. Discussion

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>19</sup> The Commission finds that the proposed

<sup>14</sup> See Securities Exchange Act Release No. 50699 (Nov. 18, 2004), 69 FR 71126 (Dec. 8, 2004) ("SRO Governance Release"). In note 148 of the SRO Governance Release, the Commission states, among other things, that it has taken the position that the fair representation requirement could be satisfied if an exchange's rules provide that members constitute at least 20% of the individuals serving on an exchange's nominating committee.

<sup>15</sup> See Article II, Section 3(a) of the Exchange's bylaws.

<sup>16</sup> See proposed amendment to Article II, Section 3(a) of the Exchange's bylaws.

<sup>17</sup> See Article II, Rule 2(a).

<sup>18</sup> See Article VI, Rule 2(b)(7) (replacing the concept of a firm's "nominee" with a specific reference to persons serving as co-specialists, market makers or floor brokers).

<sup>19</sup> In approving this proposal, the Commission has considered its impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

rule change is consistent with Section 6(b)(5) of the Act,<sup>20</sup> which requires that the rules of an exchange be designed, among other things, to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest.

The Commission also finds that the proposed rule change is consistent with Section 6(b)(3) of the Act,<sup>21</sup> which requires that the rules of a national securities exchange assure the fair representation of its members in the selection of its directors and administration of its affairs, and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer. The proposed rule change contemplates that three of the twelve members, or at least 20%, of the Exchange's Board, will be STP Participant Directors, one in each of the Board's three classes.<sup>22</sup> In addition, the Commission believes that the petition process for nominating STP Participant Directors affords Exchange participants a fair role in the selection of the Exchange's participant directors. Further, the Commission notes that because one class of the Board stands for election each year, and each Board class has one STP Participant Director, participants will be able to select an STP Participant Director each year. In addition, the filling of any STP Participant Director vacancies will be subject to the petition process. Accordingly, the Commission believes that the designation of three of the Exchange's twelve directors as STP Participant Directors, as well as the manner in which such directors will be nominated and elected, satisfies the fair representation requirement in Section 6(b)(3) of the Act.<sup>23</sup>

The Exchange also proposes to reduce the size of the Nominating & Governance Committee from six to four members. The Commission notes that two of the four members, or 50%, of the Committee will be public directors, thus preserving the current percentage of public directors on the Committee. The Commission also notes that one of the two participant directors on the Committee is not a representative of any of the Investor Firms to preserve fair representation on the Committee. The

<sup>20</sup> 15 U.S.C. 78f(b)(5).

<sup>21</sup> 15 U.S.C. 78f(b)(3).

<sup>22</sup> See SRO Governance Release, *supra* note 14.

<sup>23</sup> 15 U.S.C. 78f(b)(3).

Commission finds that the composition of the Committee is consistent with Section 6(b)(3) of the Act.<sup>24</sup>

The Exchange also proposes to change its rules so that only participants firms, and not individuals, must hold a trading permit in order to be able to trade on the Exchange.<sup>25</sup> The Exchange has stated that the reason for the proposed change is to reduce the number of trading permits to be more consistent with other exchanges that operate automated markets. The Commission has approved similar proposed rules for other markets,<sup>26</sup> and believes that the Exchange's proposal is similarly consistent with the Act.

Section 6(b)(3) of the Act also requires that one or more directors of an exchange shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer.<sup>27</sup> The proposed changes to the Exchange's Board provide that six of the twelve Exchange directors will be "public directors."<sup>28</sup> The Commission notes that public directors still must comprise 50% of the Exchange's Board under the proposal. Accordingly, the Commission finds the proposed rule change consistent with the Act.

### IV. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>29</sup> that the proposed rule change (SR-CHX-2006-23), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>30</sup>

**Nancy M. Morris,**

*Secretary.*

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<sup>24</sup> *Id.*

<sup>25</sup> See *supra* Part II ("One Trading Permit per Participant").

<sup>26</sup> See, e.g., NYSE Arca Rule 1(n) (defining "ETP Holder"); NSX Rule 1.5E(1) (defining the term "ETP"); NSX Rule 1.5P(1) (defining "person associated with an ETP Holder").

<sup>27</sup> 15 U.S.C. 78f(b)(3).

<sup>28</sup> See *supra* note 6. Presently, the Exchange's Board is comprised of thirteen directors, seven of whom are public directors.

<sup>29</sup> 15 U.S.C. 78s(b)(2).

<sup>30</sup> 17 CFR 200.30-3(a)(12).