

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54364; File No. SR-BSE-2006-20)

August 25, 2006

Self-Regulatory Organizations; Boston Stock Exchange, Inc.; Order Granting Approval of Proposed Rule Change and Amendment Nos. 1 and 3 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 5 to Create a New Electronic Trading Facility, the Boston Equities Exchange (“BeX”), to be Operated by BSX Group, LLC

**I. Introduction**

On May 5, 2006, the Boston Stock Exchange, Inc. (“BSE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934, as amended (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change relating to the creation of a new electronic trading facility, the Boston Equities Exchange (“BeX”), which is owned and will be operated by BSX Group, LLC (“BSX”). On June 1, 2006, the BSE filed Amendment No. 1 to the proposed rule change.<sup>3</sup> On June 15, 2006, the BSE filed Amendment No. 3 to the proposed rule change.<sup>4</sup> The proposed rule change, as amended, was published for comment in the Federal Register on June 29, 2006.<sup>5</sup> The Commission received no comments regarding the proposal, as amended. On August 25, 2006, the BSE filed Amendment Nos. 4 and 5 to the proposed rule change.<sup>6</sup> This order approves the

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

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

<sup>3</sup> Amendment No. 1 superseded and replaced the original filing in its entirety. Amendment No. 2 was withdrawn by BSE on June 9, 2006.

<sup>4</sup> Amendment No. 3 superseded and replaced the original filing and Amendment No. 1 in their entirety.

<sup>5</sup> See Securities Exchange Act Release No. 54035 (June 22, 2006), 71 FR 37135.

<sup>6</sup> Amendment No. 5 replaced Amendment No. 4, which was withdrawn due to a technical problem in transmission. In Amendment No. 5, the BSE made changes to the proposed rule change to clarify its discussion of the BSX Operating Agreement and correct several inconsistencies between the description of the BSX Operating Agreement and the

proposed rule change, as amended, grants accelerated approval to Amendment No. 5 to the proposed rule change, and solicits comments from interested persons on Amendment No. 5.

## II. Description of the Proposal

### A. Overview

The Exchange proposes to establish a new electronic trading facility,<sup>7</sup> BeX, for the use of BSE members, including the new category of “Electronic Access Members” (“EAMs”),<sup>8</sup> and their customers. BeX is owned and will be operated by BSX, of which the Exchange is currently a majority owner. The Exchange seeks the Commission’s approval of the proposed governance structure of BSX as reflected in the amended and restated operating agreement of BSX<sup>9</sup> (“BSX

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agreement’s text. In addition, Amendment No. 5 amended proposed Section 6 of Chapter XVIII of the BSE Rules to align the cure period for a violation of the Ownership Concentration Limit with that contained in Section 8.5(b) of the BSX Operating Agreement. Amendment No. 5 also updated Schedule 2 of the BSX Operating Agreement to provide current information on the ownership interests of the BSX Members, and made other technical, non-substantive changes to the proposed rule change.

<sup>7</sup> Pursuant to Section 3(a)(2) of the Act, the term “facility” when used with respect to an exchange, includes “its premises, tangible or intangible property whether on the premises or not, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service.” 15 U.S.C. 78c(a)(2).

<sup>8</sup> The term “EAMs” is used herein to signify both Electronic Access Members and Electronic Access Memberships, as applicable.

<sup>9</sup> The rules of an exchange, as defined in Section 3(a)(27) of the Act, 15 U.S.C. 78c(a)(27), include the constitution of the exchange, its articles of incorporation, bylaws, and rules. Thus, any changes to these BSE instruments need to be filed pursuant to Section 19(b) of the Act and Rule 19b-4 thereunder. The operating agreement of the BSX is the organizational document of BSX, not the BSE. Nevertheless, certain provisions in agreements of this nature may be deemed the rules of an exchange when they are the stated policies, practices, and interpretations, as defined in Rule 19b-4 under the Act, of the exchange. Any proposed rule or any proposed change in, addition to, or deletion from any such rules of an exchange must be filed pursuant to Section 19(b) of the Act and Rule 19b-4 thereunder.

Operating Agreement”),<sup>10</sup> and changes to its Constitution to provide for EAMs and to its Constitution and rules to further transfer and ownership provisions of the BSX Operating Agreement. Separately, the Commission is approving the trading rules governing the first phase of the BeX trading system.<sup>11</sup>

Under various agreements between BSE and BSX, BSX would operate BeX as a facility of the BSE. All the assets and liabilities that solely support the equities trading business of the BSE would be transferred to BSX. Upon restructuring, however, the BSE would continue to be the self-regulatory organization (“SRO”) for the equities business that will be operated on BeX.<sup>12</sup> All the proposed changes to facilitate this restructuring have been set forth in the BSX Operating Agreement and would be reflected in the changes to the Exchange’s Constitution and a related provision in the Exchange’s Rules of the Board of Governors (“BSE Rules”). The Exchange also proposes to amend its Constitution and the BSE Rules to create a new category of BSE members to be known as EAMs. EAMs would be entitled to trade equity securities on BeX

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<sup>10</sup> Unlike a corporation’s charter or bylaws, the BSX Operating Agreement is a signed contract among the Members of BSX. These Members are currently the sole owners, or “unitholders,” of BSX. While ownership interests in a corporation are generally referred to as “shares” or “stock,” ownership interests in an LLC are referred to as “units.” See infra note 16 and accompanying text for a definition of “Member,” as used in the BSX Operating Agreement.

<sup>11</sup> See Securities Exchange Act Release No. 54365 (August 25, 2006). The Commission notes that the BSE has filed another proposed rule change setting forth proposed rules to implement the second phase of BeX and to comply with the Commission’s Regulation NMS under the Act, which the Commission has published for comment. See Securities Exchange Act Release No. 54291 (August 8, 2006), 71 FR 47264 (August 16, 2006) (File No. SR-BSE-2006-30).

<sup>12</sup> The BSE states that the proposed restructuring would not affect the Boston Options Exchange facility (“BOX Market”) which is controlled by the Boston Options Exchange Group, LLC (“BOXG”). The BSE is a founding member and part owner of the BOXG, and the BOX Market is regulated by Boston Options Exchange Regulation, LLC (“BOXR”), a wholly-owned subsidiary of the BSE to which the BSE has delegated regulatory oversight authority for the BOX Market.

without purchasing a seat on the Exchange. BSE Members have approved the proposed changes to the Constitution.

The Exchange believes that by restructuring the control of its equities business as a limited liability company with business control and management by the directors and officers of BSX, the new entity would have greater flexibility to build and execute approaches designed to improve its competitive position, including the development of strategic relationships. Furthermore, the Exchange anticipates that by restructuring so that a separately controlled organization is responsible for the operation of its equities business, the management of BSX will be better able to respond quickly to competitive pressures and to make changes to the operation as market conditions warrant. The Exchange indicated that the proposed BSX structure would be substantially the same as that which the Exchange has established for its options trading business,<sup>13</sup> except that the BSE, rather than a wholly-owned subsidiary such as BOXR, directly would regulate the Exchange's equities trading business. The Exchange also believes that by conferring trading privileges on EAMs that do not bear the costs of seat ownership, it can increase the revenue of its equities business.<sup>14</sup>

#### **B. Current Ownership and Control of BSX**

According to the Exchange, BSX will be run by its management with limited policy direction by BSE members. BSX will be controlled by its own board of directors ("BSX Board"), which would be responsible for the commercial governance of BeX, subject at all times to BSE's overriding regulatory responsibility. Currently, there are six unitholders who have a

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<sup>13</sup> See Securities Exchange Act Release Nos. 49067 (January 13, 2004), 69 FR 2761 (January 20, 2006) and 49065 (January 13, 2004), 69 FR 2768 (January 20, 2004).

<sup>14</sup> The Exchange has represented that it intends to keep fees imposed upon EAMs consistent with the applicable fees imposed upon non-EAMs and that it intends to file with the Commission a separate rule filing to address all fees related to the BeX trading system, including EAM and non-EAM fees.

direct controlling interest in BSX: the BSE (approximately 58.33 percent); and Citigroup Financial Strategies Inc. (“Citi”), Credit Suisse First Boston Next Fund Inc. (“CSFB”), LB 1 Group, Inc. (“Lehman”), Fidelity Global Brokerage Group, Inc. (“Fidelity”), and Merrill Lynch L.P. Holdings Inc. (“Merrill”) (each approximately 8.33 percent). There are currently no other unitholders in BSX. These six unitholders are termed the “Founding Members” of BSX.

### **C. Changes in Ownership of BSX**

Section 8.1(a) of the BSX Operating Agreement provides that, except in certain limited circumstances, no person may directly or indirectly transfer any units, or any rights arising from the ownership of units, without the prior approval of the board of directors of BSX (the “BSX Board”).<sup>15</sup> To be eligible for such approval, the proposed transferee must: (1) have sufficient financial assets to support such a transfer; (2) be able to carry out its duties to BSX as a Member<sup>16</sup> under the BSX Operating Agreement (“BSX Member”), if admitted; and (3) be under no regulatory or governmental disqualification.

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<sup>15</sup> As defined in Section 8.1(a) of the BSX Operating Agreement, the term “Transfer” (“transfer” as used herein) means: to transfer, dispose of, sell, lend, pledge, hypothecate, encumber, assign, exchange, participate, subparticipate, or otherwise transfer in any manner. As defined in Section 1.1 of the Agreement the term “Person” (“person” as used herein when used with respect to provisions in the Agreement) means: an individual, corporation, association, general or limited partnership, organization, business, firm, limited liability company, joint venture, trust, estate, or other entity, association, or organization, whether constituting a legal entity or not.

<sup>16</sup> Section 1.1 of the BSX Operating Agreement defines a “Member,” in brief, as each person admitted and named as a Member on Schedule 2 of the Operating Agreement (which currently lists the Members as BSE, Citi, CSFB, LB 1, Fidelity, and Merrill), and any person admitted to BSX as an additional or substitute member as provided by the agreement. The definition makes explicit that a transferee or assignee (including the personal representatives of a Member) of a limited liability company interest in BSX shall not be a BSX Member, and that no transferee or assignee (except as specifically provided with respect to BSE) other than a duly admitted BSX Member shall have any right whatsoever to vote or consent to any action with respect to BSX unless and until the transferee or assignee is admitted as a BSX Member in accordance with the provisions of the Agreement.

Section 8.1(b) provides, in addition, that a person (other than an affiliate of an existing BSX Member<sup>17</sup>) shall be admitted to the BSX as an additional or substitute BSX Member only upon that person's execution of a counterpart of the BSX Operating Agreement to evidence its written acceptance of the terms and provisions of the Agreement, and acceptance thereof by resolution of the BSX Board, which may be given or withheld in the sole discretion of the BSX Board; and approval of the BSX Board.<sup>18</sup>

Section 8.4(a), among other things, provides that no transfer of any units may take place if the transfer is prohibited by the BSX Operating Agreement or any state, federal or provincial securities laws. Section 8.4(c) provides that any transfer of units that contravenes Article 8 of the Operating Agreement will be void ab initio and ineffectual, and will not bind or be recognized by BSX.

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<sup>17</sup> As defined in Section 1.1 of the BSX Operating Agreement, "Affiliate" ("affiliate" as used herein) means, with respect to any person, any other person controlling, controlled by or under common control with, that person. As used in this definition, the term "control" means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. A person is presumed to control any other person, if that person: (i) is a director, general partner, or officer exercising executive responsibility (or having similar status or performing similar functions); (ii) directly or indirectly has the right to vote 25 percent or more of a class of voting securities or has the power to sell or direct the sale of 25 percent or more of a class of voting securities of the person; or (iii) in the case of a partnership, has contributed, or has the right to receive upon dissolution, 25 percent or more of the capital of the partnership.

<sup>18</sup> Further under Section 8.1(b), if the person is a transferee, the person would need to submit an agreement in writing to its assumption of the obligations of its assignor under the BSX Operating Agreement, and acceptance thereof by resolution of the BSX Board, which acceptance may be given or withheld in the sole discretion of the BSX Board; and confirmation by the BSX Board that the transfer was permitted by the Agreement.

Section 8.1(b) also provides that, whether or not a transferee who acquired any units has accepted in writing the terms and provisions of the BSX Operating Agreement and assumed in writing the obligations its predecessor in interest, the transferee shall be deemed, by the acquisition of such units, to have agreed to be subject to and bound by all the obligations of the Agreement with the same effect and to the same extent as any predecessor in interest of the transferee.

Section 8.4(d) of the BSX Operating Agreement provides that, beginning after Commission approval of this proposed rule change, BSX must provide the Commission with written notice ten days prior to the closing date of any acquisition that results in a BSX Member's percentage ownership interest in BSX, alone or with any affiliate, meeting or crossing either the 5 percent, 10 percent, or 15 percent thresholds. Section 8.4(e) provides that any transfer of BSX units that results in the acquisition and holding by any person, alone or together with an affiliate, of an interest that meets or crosses the 20 percent threshold or any successive five percent threshold (i.e., 25 percent, 30 percent, etc.) would trigger an amendment to the BSX Operating Agreement that would have to be filed with the Commission under Section 19(b) of the Act.<sup>19</sup> In addition, Section 8.4(e) provides that any transfer of BSX units that would reduce BSE's ownership in BSX below the 20 percent threshold would require a proposed rule change under Section 19(b) of the Act. Moreover, Commission approval would be required to permit any person, alone or together with any affiliate, to control 20 percent of the Total Votes (as defined in Section 4.4(a) of the BSX Operating Agreement).

Section 8.4(f) of the BSX Operating Agreement provides for indirect changes in control of BSX. Any person that acquires a controlling interest (i.e., an interest of 25 percent or greater) in a BSX Member that holds 20 percent or more of BSX units would be required to agree to become a party to the BSX Operating Agreement and abide by its terms.<sup>20</sup> The amendment to

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<sup>19</sup> For example, assume that a person owns a 28 percent interest in BSX and buys units constituting an additional three percent. Because the person would cross the 30 percent ownership threshold, the acquisition would trigger an amendment to the BSX Operating Agreement that would have to be submitted as a proposed rule change. However, an acquisition of an additional three percent that would raise the person's interest from 31 percent to 34 percent would not trigger a proposed rule change.

<sup>20</sup> For example, assume that Company XYZ, a BSX Member, owns a 25 percent interest in BSX and Firm ABC acquires 35 percent of Company XYZ. Firm ABC must execute an amendment to the BSX Operating Agreement whereby Firm ABC agrees to become a

the BSX Operating Agreement caused by the addition of the indirect controlling party would require a filing with the Commission pursuant to Section 19(b) of the Act. The rights and privileges of the BSX Member in whom a controlling interest is acquired would be suspended until the amendment becomes effective under the Act or until the indirect controlling party ceases to have a controlling interest in the BSX Member.

In addition to the requirements for proposed rule changes relating to direct and indirect changes in control of BSX, Section 4.3(c) of the BSX Operating Agreement prohibits BSX Members from entering into voting trust agreements with respect to their ownership interests in BSX.<sup>21</sup>

**D. Commission Jurisdiction Over Owners of BSX**

Under Section 18.6(a), each BSX Member, by becoming a party to the BSX Operating Agreement, would be required to acknowledge that, to the extent that they are related to BSX activities, the books, records, premises, officers, directors, agents, and employees of the BSX Member will be deemed to be the books, records, premises, officers, directors, agents, and employees of BSE for the purpose of and subject to oversight pursuant to the Act. Under Section 18.6(b), each BSX Member and the officers, directors, agents, and employees thereof are required to irrevocably submit to the jurisdiction of the U.S. federal courts, the Commission, and BSE<sup>22</sup> for the purposes of any suit, action, or proceeding pursuant to the U.S. federal securities laws and the rules or regulations thereunder, arising out of or relating to BSX activities or

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new party to the agreement and abide by all its provisions. Furthermore, a person could become subject to Section 8.4(f) of the BSX Operating Agreement if it acquires an indirect controlling interest in a BSX Member.

<sup>21</sup> See Section II.G below for a discussion of ownership restrictions and voting limitations on BSX Members who are also BeX Participants.

<sup>22</sup> Such jurisdiction includes Delaware for matters relating to the organization or internal affairs of BSX.

Section 18.6(a). Also, under Section 18.6(b), each BSX Member and the officers, directors, agents, and employees thereof must waive, and agree not to assert by way of motion, as a defense or otherwise in any such suit, action, or proceeding, any claim that they are not personally subject to the jurisdiction of the Commission; that the suit, action or proceeding is an inconvenient forum; or that the venue of the suit, action, or proceeding is improper or may not be enforced in or by such courts or agency.

Section 18.6(c) of the BSX Operating Agreement provides that the BSE and each other BSX Member must take such action as is necessary to ensure that such BSX Member's officers, directors, and employees consent to the applicability of Section 18.6 with respect to their BSX-related activities.

#### **E. Governance of BSX**

Section 4.2(b) of the BSX Operating Agreement gives the BSX Board the power and responsibility to manage the business of BSX, select and evaluate the performance of its senior executive, and establish and monitor capital and operating budgets. Section 4.1(a) provides that the BSX Board will consist of between five and 15 directors. Under Section 4.1(b) BSE is entitled to designate two directors and Citi, CSFB, Lehman, Fidelity and Merrill are entitled to designate one director each. Moreover, for as long as BeX remains a facility of the Exchange, BSE has the right to designate at least one director.<sup>23</sup> Section 4.1(d) provides that, in the event of the addition of any new BSX Members or the transfer of interest from one BSX Member to another BSX Member, the BSX Board will determine the number of board seats, if any, to be designated by the new or transferee BSX Member and will determine the disposition of the board

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<sup>23</sup> The Commission notes that Section 4.1(b) also provides that if any Founding Member maintains an ownership percentage of 3.00 percent or greater, it will be entitled to designate one director.

seats designated by any transferring BSX Member.<sup>24</sup> Section 4.1(e) further provides that the BSX Board may increase its size and/or provide for representation for new or transferee BSX Members with ownership interests equal to or greater than five percent. Section 4.8 provides that, except as otherwise expressly provided in the BSX Operating Agreement or as requested by the BSX Board, no BSX Member may take part in the day-to-day management or operation of the business or affairs of BSX.

Pursuant to Section 4.1(c) of the BSX Operating Agreement, a director would be terminated by the BSX Board: (i) in the event the director has violated any provision of the BSX Operating Agreement or any federal or state securities law; or (ii) if the BSX Board determines that such action is necessary or appropriate in the public interest or for the protection of investors. In addition, Section 4.2(a) requires each director to comply with the federal securities laws and the rules and regulations thereunder and to cooperate with the Commission and BSE pursuant to their regulatory authority and the provisions of the BSX Operating Agreement. Section 4.2(a) also requires each director to take into consideration whether his or her actions as a director would cause BSX to engage in conduct that fosters, and does not interfere with, its ability to prevent fraudulent and manipulative actions and practices; promote just and equitable principles of trade; foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities; remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, protect investors and the public interest.

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<sup>24</sup> See Amendment No. 5 to the proposal.

**F. Regulation of BSX**

BeX is owned and will be operated by BSX, but it will be a facility of the Exchange. Accordingly, BSE has responsibility under the Act for the BeX facility. In this regard, Sections 12.1 and 15 of the BSX Operating Agreement each provide that the books, records, premises, officers, directors, agents, and employees of BSX shall be deemed to be the books, records, premises, officers, directors, agents, and employees of BSE for the purpose of and subject to oversight pursuant to the Act. Moreover, under Section 5.3 of the BSX Operating Agreement, each BSX Member agrees to comply with the federal securities laws and the rules and regulations thereunder; to cooperate with the Commission and BSE pursuant to their regulatory authority and the provisions of the BSX Operating Agreement; and to engage in conduct that fosters and does not interfere with BSX's ability to prevent fraudulent and manipulative acts and practices; promote just and equitable principles of trade; foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities; remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, protect investors and the public interest.

Section 5.8 of the BSX Operating Agreement further provides that, after appropriate notice and opportunity for hearing, the BSX Board, by a two-thirds vote, including the affirmative vote of BSE and excluding the vote of the BSX Member subject to sanction, may suspend or terminate a BSX Member's voting privileges or membership: (i) in the event such BSX Member is subject to a statutory disqualification, as defined in Section 3(a)(39) of the Act; (ii) in the event such BSX Member has violated any provision of the BSX Operating Agreement

or any federal or state securities law; or (iii) if the BSX Board determines that such action is necessary or appropriate in the public interest or for the protection of investors.

In addition, Section 4.4(a) of the BSX Operating Agreement provides that BSX may not take any “Super Major Action” unless such action is approved by directors holding at least 75 percent of the total votes of the BSX Board, including the affirmative vote of all of the votes of directors designated by four of the Founding Members, plus the affirmative vote of all of the votes of directors designated by BSE. A “Super Major Action” is defined in Section 4.4(b) to include, among other things: a merger or consolidation involving BSX; a sale of any material portion of its assets; appointing directors to afford representation to BSX Members, other than Founding Members, having a percentage interest less than five percent; operating the BeX with a Regulatory Services Provider other than the BSE or an affiliate of the BSE; making a material change to the market structure of BeX; the acquisition of any units by any person that results in such person holding an aggregate percentage interest in BSX equal to or greater than 20 percent; altering the provisions for BSX Board membership for the Founding Members; entry by BSX into any other line of business other than the development, operation, and ownership of the BeX, except as expressly contemplated by the BSX Operating Agreement and the Related Agreements;<sup>25</sup> entering into any agreement, commitment, or transaction with a BSX Member or any of its affiliates other than transactions or agreements upon commercially reasonable terms that are no less favorable to BSX than BSX would obtain in a comparable transaction or agreement with a third party; taking any action which would effect the voluntary, or which

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<sup>25</sup> Section 1.1 of the BSX Operating Agreement defines “Related Agreements” as the BSE Facility Services Agreement and any other agreement among or between any of the Members and BSX, or to which the Members or BSX are otherwise parties, in all cases necessary for the conduct of the business of BSX.

would precipitate an involuntary, dissolution or winding up of BSX; and entering into any partnership, joint venture or other similar joint business undertaking.

Section 16.2(a) of the BSX Operating Agreement provides that a BSX Member may not disclose any confidential information of BSX to any person except as expressly provided by the BSX Operating Agreement. However, Section 16.2(b) provides exceptions for, among other things, disclosure required by the federal securities laws or in response to a request by the Commission pursuant to the Act or by the BSE. Similarly, Section 16.5 of the BSX Operating Agreement provides that nothing in the BSX Operating Agreement should be interpreted as to limit or impede the rights of the Commission or BSE to access or examine confidential information to the Commission or BSE.

**G. Ownership Restrictions and Voting Limitations on BSX Members Who Are Also BeX Participants**

Section 8.5 addresses BSX ownership concentration limits and voting limitations. Section 8.5(a) limits any person who, either alone or with its affiliates, is a BeX market participant (“BeX Participant”)<sup>26</sup>, from owning in the aggregate more than 20 percent of the outstanding units of BSX (the “Ownership Concentration Limit”).<sup>27</sup> Section 8.5(b) sets forth

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<sup>26</sup> The BSX Operating Agreement defines “BeX Participant” as “a firm, or organization that is registered with the BSE pursuant to the BSE Rules for purposes of participating in equities trading on the BeX.”

<sup>27</sup> The proposed rule change also includes a related provision to be added to Article IX of the BSE Constitution prohibiting BSE members, either alone or with any affiliates, from owning beneficially, at any time, any interest in BSX representing in the aggregate more than 20 percent of the then outstanding units of BSX. In tandem, the proposed rule change would add a provision to Chapter XVIII of the BSE Rules stating that the Exchange must: (1) provide notice to a member within five business days of learning of the member’s failure to comply with this ownership limitation; (2) allow the member fifteen calendar days to respond; (3) absent an adequate response, schedule a hearing before a Hearing Panel consisting of a Hearing Officer, who would be the Chairman of the Panel, and at least two members of the Hearing Committee within thirty calendar days; and (4) render its decision as to the existence of a violation no later than ten

that any person that is not a BeX Participant that, alone or together with affiliates exceeds the Ownership Concentration Limit, and subsequently becomes a BeX Participant, must, within 180 days, transfer sufficient interest so that the person who is also a BeX Participant does not exceed the Ownership Concentration Limit.

Section 8.6 of the BSX Operating Agreement imposes a “voting limitation” on any BSX Member who, alone or together with an affiliate, has an ownership interest in BSX in excess of 20 percent and is also a BeX Participant. The interests owned by such BSX Member in excess of 20 percent are deemed “excess units.” No BSX Member who is also a BeX Participant is permitted to vote or give proxy rights to vote with respect to any excess units. However, Section 8.6 further provides that the excess units would be considered for quorum purposes of any meeting of the BSX Board, and the person presiding over quorum and vote matters would vote the excess units in the same proportion that the units held by the other BSX Members are voted.

#### **H. Electronic Access Members**

The Exchange proposes to amend its Constitution to permit a new type of member and membership, EAMs, which would allow persons or firms to conduct business on the Exchange without having to purchase seats.<sup>28</sup> The Exchange would issue EAMs to persons or entities that wish to engage in equity transactions on the Exchange. Those seeking to become EAMs would

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calendar days following the date of the hearing. Should the Hearing Panel determine that a violation exists, all trading rights and privileges of the BSE member would be suspended. See Amendment No. 5 to the proposed rule change.

The proposed rule change also would add to Article IX of the BSE Constitution a provision stating that, without prior Commission approval, the BSE or any entity with which it is affiliated could not directly acquire or maintain an ownership interest in a BSE Member. In addition, no BSE member could be or become an affiliate of the Exchange or any affiliate of an affiliate of the BSE.

<sup>28</sup> See proposed amendments to Article I, Section 3 and Article IX, Sections 1-3 of the BSE Constitution.

need to satisfy all the requirements for membership on the Exchange, as set forth in the Exchange Constitution and Rules, with the exception of purchasing a seat.

EAM memberships would provide access to the BeX, but would not confer the same rights and privileges as are conferred by Exchange seats. Specifically, EAMs would be represented on the BSE Board of Governors and on its various constitutional committees in the same capacity and to the same extent as BSE Members. They also would have the right to vote in the same capacity as BSE Members, except with respect to Exchange ownership matters -- specifically those matters relating to mergers, consolidations, dissolution, liquidation, transfer, or conversion of assets of the Exchange. For the purposes of the Act, EAMs would be considered members of the BSE. There would be no limit to the number of EAMs issued, provided that, in the determination of the BSE Board of Governors, sufficient operational capacity existed to grant additional EAMs. BSE seat holders, who would retain ownership interest in the Exchange, also would have access to the BeX, and so would not need to separately be approved as EAMs.

### **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>29</sup> In particular, the Commission finds that the proposed rule change, as amended, is consistent with Section 6(b)(1) of the Act,<sup>30</sup> which requires a national securities exchange to be so organized and have the capacity to carry out the purposes of the Act and to enforce compliance by its members and persons associated with its members with the provisions of the Act, the rules or regulations thereunder, and the rules of the exchange.

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<sup>29</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>30</sup> 15 U.S.C. 78f(b)(1).

The Commission also finds that the proposed rule change, as amended, is consistent with Section 6(b)(3) of the Act,<sup>31</sup> which, among other things, requires that the rules of an exchange ensure fair representation of its members in the selection of its directors and administration of its affairs.

The Commission also finds that the proposed rule change, as amended, is consistent with Section 6(b)(5) of the Act,<sup>32</sup> which requires that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities; 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; and are not designed to unfairly discriminate between customers, issuers, brokers, or dealers.

**A. BeX as a Facility of the Exchange**

The Commission believes that the proposed rule change is consistent with Section 6(b)(1) of the Act<sup>33</sup> in that upon establishing the BeX as an Exchange facility and entering into the relationship with BSX described above, BSE will remain so organized, and have the capacity to be able, to carry out the purposes of the Act. The Commission further believes that BSE's proposal for BSX to operate BeX as a facility of BSE is properly filed under Section 19(b) of the Act and Rule 19b-4 thereunder, and that BeX is not required, separate from BSE, to apply for registration as a national securities exchange pursuant to Section 6(a) of the Act.<sup>34</sup> The

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<sup>31</sup> 15 U.S.C. 78f(b)(3).

<sup>32</sup> 15 U.S.C. 78f(b)(5).

<sup>33</sup> 15 U.S.C. 78f(b)(1).

<sup>34</sup> 15 U.S.C. 78f(a).

Commission notes that it previously approved a similar structure with respect to the operation of the BOX, a facility of the Exchange, by BOXG.<sup>35</sup>

The Commission believes that BSX can be approved as the operator of the BeX facility since BSE will be the SRO for the BeX facility, and BSX will conduct the facility's business operations in a manner consistent with the regulatory and oversight responsibilities of BSE.<sup>36</sup>

Although BSX itself will not carry out any regulatory functions, all its activities must be consistent with the Act. Under Section 5.3 of the BSX Operating Agreement, each BSX Member agrees to comply with federal securities law; to cooperate with the Commission and BSE pursuant to their regulatory authority and the provisions of the BSX Operating Agreement; and to engage in conduct that fosters and does not interfere with BSX's ability to prevent fraudulent and manipulative acts and practices; promote just and equitable principles of trade; foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities; remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, protect investors and the public interest. Section 4.2(a) also requires each BSX director to cooperate with the Commission and BSE in carrying out his or her regulatory responsibilities. These provisions reinforce the notion that BeX, as a facility of an exchange, is not solely a commercial enterprise; it is an integral part of an SRO registered pursuant to the Act and, as such, is subject to obligations imposed by the Act.

These obligations endure as long as BeX is a facility of the Exchange, regardless of the size of BSE's ownership interest in BSX, the operator of the facility. The BSE currently owns a controlling interest in the operator of the facility and if, in the future, it wishes to reduce its

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<sup>35</sup> See supra note 13 and accompanying text.

<sup>36</sup> BSE will regulate the BeX market via a contract.

interest in BSX to below 20 percent, pursuant to Section 8.4(e)(ii) of the BSX Operating Agreement the Exchange would be required to file such a transfer of units as a proposed rule change under Section 19(b) of the Act. The Commission believes that this is a reasonable measure to alert the Commission to a significant reduction of BSE's interest in BSX. Such a reduction could warrant additional review of the BSX Operating Agreement to ensure that BSE's responsibilities as the SRO of the BeX facility are not compromised.

The BSX Operating Agreement includes additional provisions that make special accommodations for BSE as the SRO of the BeX facility. For example, Section 4.4(a) of the BSX Operating Agreement provides that BSX may not take any Super Major Action unless such action is approved by seventy-five percent of the total votes of the BSX Board, including the affirmative vote of four of the directors designated by the Founding Members and all the directors designated by BSE. Section 4.1(b) of the BSX Operating Agreement provides that, with its present ownership interest, BSE is entitled to two seats on the BSX Board. Section 4.1(b) also gives BSE a perpetual right, so long as BeX remains a facility of BSE, to designate at least one director on the BSX Board regardless of whether it maintains any ownership interest in BSX. In addition, despite its statement of a general prohibition against BSX Members committing or acting on behalf of BSX, Section 5.2 would permit BSE to act on behalf of BSX in regulatory matters. Finally, Sections 16.2(b) and 16.5 of the BSX Operating Agreement allows BSE, and the other BSX Members, their officers, directors, agents, and employees, to disclose to the Commission confidential information.

Because the BSE has proposed to operate BeX as its facility, BSE's obligations under the Act extend to its members' activities on BeX, as well as to the operation and administration of BeX. The Commission believes that Section 19 of the Act affords the Commission the ability to

determine whether BSE's proposal is consistent with the Act, as would a separate application by BeX to register as a national securities exchange. More specifically, the Commission believes that these provisions, described above, are consistent with the Act and enhance the ability of BSE to carry out its self-regulatory responsibilities with respect to its BeX facility.

**B. Changes in Control of BSX**

The Commission believes that the restrictions in the BSX Operating Agreement on direct and indirect changes in control of BSX are sufficient so that BSE would be able to carry out its self-regulatory responsibilities and that the Commission can fulfill its responsibilities under the Act. Schedule 2 of the BSX Operating Agreement lists all BSX Members, the number of units each holds, and the percentage of ownership in BSX that such units represent. A change to this schedule (as well as any other provision of the BSX Operating Agreement) would need to be filed with the Commission if so required under Section 19(b) of the Act and Rule 19b-4 thereunder. In addition, Section 8.4(e) of the BSX Operating Agreement provides that any proposed transfer of BSX units that would cause the acquirer to meet or cross the 20 percent ownership threshold or any subsequent five percent ownership threshold (e.g., 25 percent, 30 percent, 35 percent, etc.) would require BSE to file a proposed rule change with the Commission pursuant to Section 19(b) of the Act.

Furthermore, Section 8.4(d) of the BSX Operating Agreement requires BSE to inform the Commission in writing at least ten days before any proposed acquisition of BSX units that would result in a BSX Member meeting or crossing the 5 percent, 10 percent, or 15 percent ownership thresholds. The Commission believes that this approach is consistent with the Act in that it is analogous to the ongoing reporting requirements of Form 1,<sup>37</sup> the application for (and

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<sup>37</sup> 17 CFR 249.1 and 17 CFR 249.1a.

amendments to the 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 or more in the exchange;<sup>38</sup> and Rule 6a-2(a)(2) under the Act<sup>39</sup> requires an exchange to update its Form 1 within ten days after any action that renders inaccurate the information previously filed in Exhibit K.

Exhibit K imposes no obligation on an exchange to report parties whose ownership interest in the exchange is less than five percent. Similarly, Section 8.4(d) of the BSX Operating Agreement requires BSE to notify the Commission of an interest in BSX only when that interest reaches five percent or more. The Commission does not believe that the identity of a party that has less than a five percent interest in a facility of a national securities exchange is a “rule of the exchange” that must be filed pursuant to Section 19(b) and Rule 19b-4(b) thereunder.

In addition, Section 8.4(f) of the BSX Operating Agreement would require an indirect controlling party to become a party to the BSX Operating Agreement. This amendment to the agreement would require a proposed rule change to be filed with the Commission pursuant to Section 19(b) of the Act. The proposed rule change would alert the Commission to the existence of a proposed indirect controlling party and present the Commission and BSE with an opportunity to determine what additional measures, if any, might be necessary to provide sufficient regulatory jurisdiction over the proposed indirect controlling party. The Commission understands that Section 8.4(f) of the BSX Operating Agreement would apply to any ultimate parent of BSX, no matter how many levels of ownership are involved, provided that a controlling

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<sup>38</sup> This reporting requirement applies only to exchanges that have one or more owners, shareholders, or partners that are not also members of the exchange. See Form 1, Exhibit K. Exhibit K applies only to the exchange itself, not to entities that operate facilities of the exchange.

<sup>39</sup> 17 CFR 240.6a-2(a)(2).

interest exists between each link of the ownership chain.

In conclusion, the Commission believes that Sections 8.4(d), (e), and (f) of the BSX Operating Agreement, together with the requirements of Section 19(b) of the Act and Rule 19b-4 thereunder, provide the Commission with sufficient authority over changes in control of BSX to enable the Commission to carry out its regulatory oversight responsibilities with respect to BSE and the BeX facility.

### **C. Regulatory Jurisdiction Over BSX Members**

The Commission believes that the terms of the BSX Operating Agreement provide the Commission and BSE with sufficient regulatory jurisdiction over the controlling parties and BSX Members to carry out their responsibilities under the Act. In Section 18.6(a), each BSX Member acknowledges that – to the extent that they are related to BSX activities – the books, records, premises, officers, directors, agents, and employees of the BSX Member are deemed to be the books, records, premises, officers, directors, agents, and employees of BSE itself for the purpose of and subject to oversight pursuant to the Act. Moreover, in Sections 12.1 and 15 of the BSX Operating Agreement, all the BSX Members acknowledge that the books, records, premises, officers, directors, agents, and employees of BSX are deemed to be the books, records, premises, officers, directors, agents, and employees of BSE for the purpose of and subject to oversight pursuant to the Act. These provisions would enable the Commission to exercise its authority under Section 19(h)(4)<sup>40</sup> of the Act with respect to the officers and directors of BSX and of all

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<sup>40</sup> 15 U.S.C. 78s(h)(4). Section 19(h)(4) authorizes the Commission, by order, to remove from office or censure any officer or director of a national securities exchange if it finds, after notice and an opportunity for hearing, that such officer or director has: (1) willfully violated any provision of the Act or the rules and regulations thereunder, or the rules of a national securities exchange; (2) willfully abused his or her authority; or (3) without reasonable justification or excuse, has failed to enforce compliance with any such

BSX Members, since all such officers and directors – to the extent that they are acting in matters related to BSX activities – would be deemed to be the officers and directors of BSE itself.

Furthermore, the records of any BSX Member – to the extent that they are related to BSX activities – are subject to the Commission’s examination authority under Section 17(b)(1) of the Act,<sup>41</sup> as these records would be deemed to be the records of BSE itself.

In addition, under the terms of Section 18.6 of the BSX Operating Agreement, each BSX Member – and each officer, director, agent, and employee thereof – must irrevocably submit to the jurisdiction of the U.S. federal courts, the Commission, and BSE for the purposes of any suit, action, or proceeding pursuant to the U.S. federal securities laws and the rules or regulations thereunder, arising out of or relating to BSX activities. In addition, each BSX Member – and each officer, director, agent, and employee thereof – must waive, and agree not to assert by way of motion, as a defense or otherwise in any such suit, action, or proceeding, any claim that it is not personally subject to the jurisdiction of the Commission; that the suit, action or proceeding is an inconvenient forum; that the venue of the suit, action, or proceeding is improper; or that the subject matter of the suit, action, or proceeding may not be enforced in or by such courts or agency. Moreover, pursuant to Section 18.6(c) of the BSX Operating Agreement, the BSE and each BSX Member are required to take such action as is necessary to ensure that such BSX Member’s officers, directors, and employees consent to the application of these requirements with respect to their BSX-related activities. Finally, under Section 5.3 of the BSX Operating Agreement each BSX Member agrees to cooperate with the Commission and BSE pursuant to their regulatory authority.

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provision by a member or person associated with a member of the national securities exchange.

<sup>41</sup> 15 U.S.C. 78q(b)(1).

The Commission also notes that, even in the absence of these provisions of the BSX Operating Agreement, Section 20(a) of the Act<sup>42</sup> provides that any person with a controlling interest in BSX would be jointly and severally liable with and to the same extent that BSX is liable under any provision of the Act, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

The Commission believes that, together, these provisions grant the Commission sufficient jurisdictional authority over the controlling parties and other BSX Members. Moreover, BSE is required to enforce compliance with these provisions because they are “rules of the exchange” within the meaning of Section 3(a)(27) of the Act.<sup>43</sup> A failure on the part of BSE to enforce its rules could result in suspension or revocation of registration under Section 19(h)(1) of the Act.<sup>44</sup>

#### **D. Ownership Restrictions on BeX Participants**

The Commission believes that the restriction on voting trust agreements in Section 4.3(c) of the BSX Operating Agreement is reasonable and consistent with the Act. In the absence of such a provision, unaffiliated parties could act in concert and evade the BSX Operating Agreement’s provisions regarding changes in control of BSX.<sup>45</sup> A voting trust agreement would not necessarily be inconsistent with the Act, but any BSX Members wishing to establish a voting trust agreement first would need to amend the BSX Operating Agreement to enable them to do so. Such amendment would require a proposed rule change, thus affording the Commission an opportunity to review the matter.

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<sup>42</sup> 15 U.S.C. 78t(a).

<sup>43</sup> 15 U.S.C. 78c(a)(27).

<sup>44</sup> 15 U.S.C. 78s(h)(1).

<sup>45</sup> However, the BSX Operating Agreement treats as belonging to a single person any BSX units held by affiliated parties of the person. See Sections 8.4(d)-(f) of the BSX Operating Agreement.

In addition, the Commission believes that the Ownership Concentration Limit,<sup>46</sup> which prevents a person from owning more than 20 percent of the outstanding units of BSX while also being a BeX Participant, along with the provision that restricts the ability of BSX Members to vote interests in excess of 20 percent, are reasonable and consistent with the Act. It is common for members who trade on an exchange to have ownership interests in the exchange. However, a member's interest could become so large as to cast doubt on whether the exchange can fairly and objectively exercise its self-regulatory responsibilities with respect to that member. A member that is also a controlling shareholder of an exchange might be tempted to exercise that controlling influence by directing the exchange to refrain from diligently surveilling the member's conduct or from punishing any conduct that violates the rules of the exchange or the federal securities laws. An exchange also might be reluctant to surveil and enforce its rules zealously against a member that the exchange relies on as its largest source of capital.

#### **E. Electronic Access Members**

The proposed rule change would enable the Exchange to issue EAMs, which would allow persons or firms to conduct business on the Exchange without having to purchase seats. EAMs would be required to satisfy all of the requirements for membership on the Exchange with the exception of having to purchase a seat. The Commission believes that the creation of EAMs is consistent with Section 6(b)(5) of the Act in that it should help remove impediments to and help perfect the mechanism of a free and open market and a national market system. The Exchange has represented that it would issue EAMs to persons or entities that wish to engage in equity transactions on the Exchange, and that there would be no limit to the number of EAMs issued if, in the determination of the BSE Board, sufficient operational capacity existed to grant additional

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<sup>46</sup> See supra notes 26-27 and accompanying text.

EAMs.<sup>47</sup> The Commission believes that the proposed rule change does not permit unfair discrimination.

The Commission also believes that the creation of EAMs is consistent with Section 6(b)(3) of the Act because the proposed rule change provides for the fair representation of the Exchange's members, including EAMs, in the selection of its directors and the administration of its affairs. The Commission notes that, for the purposes of the Act, EAMs would be considered members of the BSE. EAMs would be represented on the BSE Board of Governors and on its various constitutional committees in the same capacity and to the same extent as other BSE members and also would have the right to vote in the same capacity as other BSE Members, except with respect to Exchange ownership matters – specifically those matters related to mergers, consolidations, dissolution, liquidation, transfer, or conversion of assets of the Exchange.<sup>48</sup>

#### **F. Accelerated Approval of Amendment No. 5**

The Commission finds good cause for approving Amendment No. 5 to the proposed rule change prior to the thirtieth day after publishing notice of Amendment No. 5 in the Federal Register pursuant to Section 19(b)(2) of the Act.<sup>49</sup>

In Amendment No. 5, the BSE made changes to the proposed rule change to clarify its

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<sup>47</sup> The BSE has represented that it intends to keep fees imposed upon EAMs consistent with the applicable fees imposed upon non-EAMs, and that it will file a separate proposed rule change to address all fees related to the BeX, including EAM and non-EAM fees.

<sup>48</sup> 15 U.S.C. 78f(b)(3). The Commission does not believe that treating EAMs as members of BSE for all purposes other than ownership issues is the only method that satisfies the fair representation requirements of Section 6(b)(3) of the Act, and reviews each SRO proposal on its own terms to determine if it is consistent with the Act.

<sup>49</sup> 15 U.S.C. 78s(b)(2). Pursuant to Section 19(b)(2) of the Act, 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 thereof, unless the Commission finds good cause for so doing.

discussion of the BSX Operating Agreement and correct several inconsistencies between the description of the BSX Operating Agreement and the Agreement's text. In addition, Amendment No. 5 amended proposed Section 6 of Chapter XVIII of the BSE Rules to align the cure period for a violation of the Ownership Concentration Limit with that contained in Section 8.5(b) of the BSX Operating Agreement. Amendment No. 5 also updated Schedule 2 of the BSX Operating Agreement to provide current information on the ownership interests of the BSX Members.

The also BSE made other technical, non-substantive changes to the proposed rule change, which raise no new or novel issues. The Commission believes that Amendment No. 5 serves to clarify and enhance the proposal and that publication of its provisions would needlessly delay the implementation of the proposal. The Commission therefore finds good cause exists to accelerate approval of Amendment No. 5, pursuant to Section 19(b)(2) of the Act.<sup>50</sup>

#### **IV. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 5, including whether Amendment No. 5 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-BSE-2006-20 on the subject line.

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<sup>50</sup> 15 U.S.C. 78s(b)(2).

Paper comments:

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

All submissions should refer to File Number SR-BSE-2006-20. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. 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. 5 of File Number SR-BSE-2006-20 and should be submitted on or before [insert date 21 days from

publication in the Federal Register].

**V. Conclusion**

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>51</sup> that the proposed rule change (SR-BSE-2006-20), as amended, and Amendment No. 3 thereto, is approved and Amendment No. 5 is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>52</sup>

Nancy M. Morris  
Secretary

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<sup>51</sup> 15 U.S.C. 78s(b)(2).

<sup>52</sup> 17 CFR 200.30-3(a)(12).