

has reported no problems with any of these trades. Moreover, as evidenced by the reports filed by the Exchange, the pilot program has been used increasingly over the past two years.

Finally, the Commission expects the Amex, through use of its surveillance procedures, to monitor closely the trading of PDRs, investment trust securities, and Index Fund Shares in the AHT facility to ensure that trading in these issues is not subject to any patterns of manipulation, trading abuses or unusual trading activity.

#### IV. Conclusion

For the reasons discussed above, the Commission believes that permanent approval of specialist participation in the AHT facility in PDRs, investment trust securities and Index Fund Shares in the manner previously approved by the Commission is appropriate and consistent with the Act.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>17</sup> that the proposed rule change (SR-Amex-98-20) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>18</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 98-29622 Filed 11-4-98; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40622; File Nos. SR-Amex-98-32; SR-NASD 98-56; SR-NASD 98-67]

### Self-Regulatory Organizations; American Stock Exchange, Inc., and National Association of Securities Dealers, Inc.; Order Granting Approval to Proposed Rule Changes and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Thereto; Relating to the Combination of the American Stock Exchange, Inc. and the National Association of Securities Dealers, Inc., Including Amendments to the Composition of the NASD Board and Relating to Policies Regarding Authority Over American Stock Exchange LLC and Composition of Board of Governors of American Stock Exchange LLC

October 30, 1998.

#### I. Introduction

Three separate filings have been submitted to the Securities and

Exchange Commission ("SEC" or "Commission") in connection with the proposed combination between the National Association of Securities Dealers, Inc. ("NASD" or "Association") and the American Stock Exchange, Inc. ("Amex").

On August 10, 1998, the NASD submitted to the Commission, pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "Exchange Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change (SR-NASD-98-56) to amend the NASD's By-Laws to reserve one NASD Board of Governors ("NASD Board") position for a person representing an NASD member firm having not more than 150 registered persons; to reserve two Board positions for the Chief Executive Officer and one Floor Governor of the American Stock Exchange LLC ("New Amex"); and to make other clarifying amendments, including the addition of certain definitions. The NASD also proposed to add corresponding clarifying amendments and definitions to the By-Laws of NASD Regulation, Inc. ("NASD Regulation") and The Nasdaq Stock Market, Inc. ("Nasdaq").

On September 3, 1998, Amex submitted to the Commission, pursuant to Section 19(b)(1) of the Exchange Act<sup>3</sup> and Rule 19b-4 thereunder,<sup>4</sup> a proposed rule change (SR-Amex-98-32) to make certain amendments to its Constitution and Rules that will become effective at the time they become the Constitution and Rules of New Amex. An amendment to SR-Amex-98-32 was filed with the Commission on October 29, 1998.<sup>5</sup>

On September 14, 1998, the NASD submitted to the Commission, pursuant to Section 19(b)(1) of the Exchange Act<sup>6</sup> and Rule 19b-4 thereunder,<sup>7</sup> a proposed rule change (SR-NASD-98-67) to state two policies regarding NASD's oversight of New Amex and the composition of the Board of Governors of New Amex.

Notice of the proposed rule changes, together with the substance of the proposals, was published for comment in Exchange Act Release Nos. 40339 (August 19, 1998), 63 FR 45547 (August 26, 1998) (SR-NASD-98-56); 40426

(September 10, 1998), 63 FR 49766 (September 17, 1998) (SR-Amex-98-32); and 40443 (September 16, 1998), 63 FR 51108 (September 24, 1998) (SR-NASD-98-67). One comment was received on the proposals.<sup>8</sup> The NASD responded to the comment letter, the substance of which is discussed in Item III below.<sup>9</sup>

## II. Description

### A. Background

On March 18, 1998, Amex and the NASD announced that their respective Boards of Governors had each agreed to enter into a merger agreement that, subject to finalization of a definitive agreement and approval by Amex Members, would result in Amex becoming a subsidiary of the NASD. On April 8, 1998, the Amex and NASD Boards each unanimously approved the terms of a definitive agreement (the "Transaction Agreement"), which was signed by the NASD and Amex as of May 8, 1998. At a Special Meeting of Members on June 25, 1998, the Amex Membership ratified the Transaction Agreement by a vote of 622 to 206.<sup>10</sup> NASD members were not required to vote on the merger.

<sup>8</sup> See letter from Bill T. Singer, Singer Frumento L.L.P., to Secretary, Commission, dated September 11, 1998 (incorporating a report from Bill T. Singer to Alan Davidson, President, Independent Broker-Dealer Association, Inc., dated September 10, 1998) ("Singer Letter"). The comment letter was written in opposition of the proposed combination of the NASD and Amex. Although the comment letter responded specifically to SR-NASD-98-56, it addressed several general issues in connection with the proposed combination. As such, the Commission has determined to treat the comment letter as if it were a comment on each of the three submitted proposals.

<sup>9</sup> See letter from T. Grant Callery, Senior Vice President and General Counsel, NASD, to Katherine A. England, Assistant Director, Market Regulation, Commission, dated October 23, 1998 ("NASD Response").

<sup>10</sup> Two-thirds approval from the Amex Membership was required in order for the transaction to pass. The Membership approved the transaction by roughly 75 percent. In connection with Amex member approval of the agreement, Amex sent to all 864 Amex Regular Members and Options Principal Members (referred to collectively as "Members") an Information Memorandum, dated May 14, 1998, describing the transaction in detail. Attached as exhibits to the Information Memorandum were the Restated Certificate of Incorporation and the new By-Laws of Amex Corp. (as hereinafter defined), and the Constitution of New Amex. Members also were provided with documents relating to the transaction ("Transaction Documents"). These included, among other items, the Transaction Agreement and exhibits thereto, including the Limited Liability Company Agreement of New Amex ("LLC Agreement") and the Technology Transfer and Development Agreement. Copies of the Transaction Agreement, the LLC Agreement, and the Technology Transfer and Development Agreement are available at the Commission's Public Reference Room under File No. SR-Amex-98-32.

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

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

<sup>3</sup> 15 U.S.C. 78s(b)(1).

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

<sup>5</sup> See Letter to Michael Walinskas, Deputy Associate Director, Division of Market Regulation, Commission, from James F. Duffy, Executive Vice President, Legal and Regulatory Policy, Amex, and Richard G. Ketchum, President and Chief Executive Officer, NASD, dated October 29, 1998 ("Amendment No. 2").

<sup>6</sup> 15 U.S.C. 78s(b)(1).

<sup>7</sup> 17 CFR 240.19b-4.

<sup>17</sup> 15 U.S.C. 78s(b)(2).

<sup>18</sup> 17 CFR 200.30-3(a)(12).

The merger has been represented as an alliance that will combine the resources of the NASD, including its technology and expertise, with Amex's auction market. It has further been represented that this combination has been designed to provide: Amex Member organizations with more efficient, less costly equity trade executions; issuers with additional listing choices; and investors with more transparent, less costly trading. The proposed technology upgrades to Amex center around a proposed "New Equity Market Structure" that, among other things, will introduce a new electronic limit order book and provide automatic execution for electronically delivered orders.<sup>11</sup> Although this program may be funded through New Amex revenues, NASD has committed up to \$110 million, including through capital contributions, loans, or guarantees of loans, to complete the New Equity Market Structure and certain other trading facility and technology upgrades.<sup>12</sup>

#### B. Reorganization of Amex

The Transaction Agreement provides that, at the Closing, Amex will transfer its exchange registration and its assets to New Amex. New Amex will assume all existing liabilities, known and unknown, of Amex. New Amex will be a national securities exchange registered under Section 6 of the Exchange Act operating a floor-based, specialist auction market with its own members and listed securities.<sup>13</sup> New Amex will

<sup>11</sup> The New Equity Market Structure, which will be subject to future SEC review and approval, intends to retain Amex's centralized, floor-based specialist auction market, but would enhance the ability to access this market either electronically or through floor brokers. It plans to provide for automatic execution of electronically delivered orders, and would use a newly developed electronic order book that would display the aggregate size and price of orders on the book away from the best bid and offer. Specialists would be precluded from charging floor brokerage fees on electronically delivered orders. In order to offset the expected loss of floor brokerage revenue, New Amex would share its transaction-based revenue with the specialists. In addition, specialists may be allowed to hand discretionary orders as agent, and their specialist affirmative obligations may be liberalized. New Amex likely will file a rule filing reflecting these proposed changes following the closing of the transaction ("Closing").

<sup>12</sup> See Technology Transfer and Development Agreement.

<sup>13</sup> Upon succeeding to the exchange registration of Amex, New Amex promptly will file necessary amendments to New Amex's registration as a national securities exchange on Form 1-A, pursuant to Rule 6a-1 under the Act. Current Amex rules will become the rules of New Amex on the date of the Closing, amended only as described herein. Any amendments to such rules proposed after the Closing will be filed by New Amex pursuant to Rule 19b-4. New Amex will also succeed to any proposed rule change filed with the Commission by

be structured as a Delaware Limited Liability Company ("LLC"), and will be jointly owned by The Amex Corporation ("Amex Corp.") (the name that Amex will use following the Closing), and the NASD (through a holding company, the NASD Market Holding Company ("Holdco")) pursuant to the LLC Agreement between the parties.<sup>14</sup> Under the LLC Agreement, Amex Corp. will be the holder of the Class A Interest and Holdco will be the holder of the Class B Interest in New Amex. Only Holdco will have a voting interest in New Amex. The NASD cannot amend the LLC Agreement without the consent of the Board of Amex Corp. or the Members of Amex Corp. (depending upon the type of change, as governed by the Transaction Documents).<sup>15</sup>

After the Closing, Amex will continue to exist as a New York not-for-profit corporation, under the name Amex Corp. Amex Corp.'s activities will be limited to holding an ownership interest in New Amex and exercising the rights incident to ownership arising under the Transaction Documents. Specifically, the Restated Certificate of Incorporation for Amex Corp. states that, except for those activities specifically mentioned in the Restated Certificate, Amex Corp. may not engage in any other business activities. Nor may it incur directly or indirectly any debt for borrowed money, or incur, without prior written consent from the Amex Corp. Chairman, any liability or make any expenditure unless the liability or expenditure is reasonable in amount and reasonably related to the corporate purpose of Amex Corp.<sup>16</sup> Except for the voting rights in connection with the request for consents from New Amex, described below, Amex Corp. will hold an otherwise nonvoting interest in New Amex. Amex Corp. will have its own Board, which will consist of the same four Floor Governors as those serving on the New Amex Board.

Amex before the Closing but not approved by the Commission by that time, and if ultimately approved such proposal would change the rules of New Amex.

<sup>14</sup> For tax consolidation purposes, the NASD will own its interest in New Amex and Nasdaq through Holdco, a wholly-owned subsidiary of the NASD.

<sup>15</sup> The New Amex Constitution provides that the Constitution may be amended by a majority vote of the New Amex Board of Governors and the holder of the Class B Interest, Holdco, without any further procedures at the SRO level except where the change would require the consent of Amex Corp. or the Amex Committee. Thus, the NASD, via its wholly-owned subsidiary Holdco, must approve, and has the power to veto, any proposed amendments to the New Amex Constitution.

<sup>16</sup> Amendments to the Restated Certificate of Incorporation of Amex Corp., which dictates the purposes and powers of Amex Corp., may not be made without the approval of the NASD.

#### C. New Amex Corporation Governance

##### 1. New Amex Board

The principal management authority of New Amex rests in the New Amex Board, which will be composed of 18 governors—including four floor governors (one of whom must be an equity specialist and at least one of whom must be a Registered Options Trader ("ROT")),<sup>17</sup> two Upstairs Industry Governors (*i.e.*, members affiliated with broker-dealers that have substantial contact with public customers); eight Public Governors;<sup>18</sup> the two most senior officers of New Amex; and two staff representatives from the NASD staff.<sup>19</sup> The eight Public Governors and two Upstairs Industry Governors will be nominated and elected by the NASD. The four Floor Governors will be nominated by Amex Corp. and elected

<sup>17</sup> The Transaction Agreement provides that on the tenth anniversary of the closing date, one additional Floor Governor will be added to the New Amex Board. The fifth Floor Governor is intended to provide Members with additional representation on the Board upon the expiration of certain contractual provisions in the Transaction Agreement.

<sup>18</sup> "Public Governor" is defined in Article II, Section .01(a)(2) of the New Amex Constitution as someone who is neither a broker or dealer in securities nor affiliated with one. The Commission notes that the NASD definition of "Public Governor" restricts persons who have material business relationships with a broker or dealer from serving as Public Governors, whereas the New Amex definition of "Public Governor" does not contain this restriction.

The NASD and Amex have represented to the Commission that they will implement certain undertakings with respect to the operation of New Amex following the Closing of the Transaction Agreement, and that these undertakings will constitute SRO rules under the Exchange Act. The NASD and Amex have indicated that there is a likelihood of overlap of Public Governors between the NASD Board and the New Amex Board. The NASD and Amex have agreed through the undertakings, and have represented to the Commission, that not more than three of the nine non-industry governors on the New Amex Board may simultaneously serve as governors on the NASD Board. In this instance only, the term "non-industry" is used to refer to the eight Public Governors on the New Amex Board, as well as to the NASD staff representative who is required to meet the definition of "Non-Industry" as defined in the NASD By-Laws. See Amendment No. 2. With respect to those serving on both the New Amex and NASD Boards, the NASD and Amex also have agreed through the undertakings, and have represented to the Commission, that New Amex will implement conflict of interest policies and procedures, consistent with those now in place at the NASD, to address the potential unique issues facing those persons that overlap between Boards. See Amendment No. 2.

<sup>19</sup> The Commission notes that the NASD will appoint as one of these representatives a person who is not an employee of and has no material business relationship with a broker or dealer or with the NASD, NASD Regulation, Nasdaq or New Amex, but who may be an officer or employee of an issuer of securities listed on Nasdaq or New Amex or traded in the over-the-counter market. See File SR-NASD-98-56, described more fully in Section ILC.3. below.

by the NASD.<sup>20</sup> The NASD may reject a Floor Governor nominee only if (i) the nominee is subject to a statutory disqualification, (ii) the nominee is subject to a proceeding or investigation which could result in a statutory disqualification, or (iii) the nominee has been disciplined by a securities SRO with respect to a matter involving fraud or a serious violation of U.S. securities laws. In the event the NASD rejects a Floor Governor nominee, the Amex Corp. has the right to select a substitute nominee.

New Amex Governors will serve a two year term in office. The four Floor Governors will be divided into two classes of two each: the first class will include an equity specialist and the second class will include an ROT. The other elected governors also will be divided into two classes, each consisting of one Upstairs Industry Governor and four Public Governors. The term of the first class will expire in 1999 and the term of the second class will expire in 2000. Elected governors will be eligible to serve no more than three consecutive two year terms, except that governors in the class of 1999 and any elected governor appointed to serve for one year or less by reason of a vacancy may be elected to serve three subsequent consecutive two year terms. The term "elected governors" does not include governors who are New Amex officers or representatives of the NASD staff, who are appointed by New Amex or the NASD, respectively.

Floor Governor nominees will be proposed either by the Amex Nominating Committee or by petition signed by at least 25 Members and will be selected by a plurality of the Regular and Options Principal Members of Amex Corp. voting together as a single class. The Amex Nominating Committee will consist of five persons: three Floor Members and two persons having no affiliation with a registered broker or dealer ("Public Members"). Each of the three principal business activities on the floor, registered specialists, registered options traders, and floor brokers, will be represented on the Amex Nominating Committee. While the existence and behavior of the Amex Nominating Committee is described in the New Amex Constitution, the Amex Nominating Committee is a committee of Amex Corp., under the By-Laws of Amex Corp. The Amex Nominating Committee will be divided into two classes: the first (terminating in 1999)

will consist of a Public Member and specialist, and the second (terminating in 2000) will consist of a Public Member, a floor broker and an ROT. Persons on the Amex Nominating Committee may not serve consecutive terms. No one affiliated with a member of the Amex Nominating Committee will be eligible as a candidate for a ticket named by it. In addition to proposing Floor Governor nominees, the Amex Nominating Committee also will propose nominees for Trustees of the Gratuity Fund, the Amex Nominating Committee, and Amex Adjudicatory Council. Candidates for these petitions can also be nominated through the independent petition process described above. Members of the Trustees of the Gratuity Fund, Amex Nominating Committee and the Amex Adjudicatory Council will be elected at the annual meeting by a plurality of Members voting together as a single class.

The filling of vacancies on the New Amex Board requires recommendation by Amex Corp. in the case of Floor Governors, and from the NASD for all other Governors. The recommendation from Amex Corp. will be made by the Amex Nominating Committee, while the NASD recommendation will be made by the NASD Nominating Committee. As with current Amex procedures, persons appointed to fill such vacancies will serve until the next annual election.

## 2. Role of the Amex Committee and Amex Corp.

Although most of the voting power in New Amex concerning the operation of New Amex will be vested in the NASD, the Transaction Agreement provides that certain actions affecting Amex Corp. Members will require their consent. Consent by Amex Corp. Members will occur through several means depending on particular circumstances, as provided for in the Transaction Agreement. The "Amex Committee" has been established under the Transaction Agreement to provide required consent under some circumstances. The Amex Committee will be required to represent and exercise its powers in the best interest of Amex Corp. and its Members, but will exist outside of both New Amex and Amex Corp.<sup>21</sup> The Amex

Committee has seven members composed of (1) three non-industry<sup>22</sup> Members, one of whom will serve as chairman; (2) one person who is not active on the floor of New Amex but who is associated with a member organization of New Amex; and (3) three Floor Members who are active on the floor of New Amex, one whose principal business is as a specialist on the Equity Market or Options Market, one whose principal business is as a registered options trader and one whose principal business is as a floor broker.<sup>23</sup>

The Transaction Agreement provides that, during certain periods, New Amex will not be able to act on certain matters without the consent of the Amex Committee, Amex Corp.,<sup>24</sup> or both. Specifically, during the period from the Closing to the fifth anniversary of the Facility Commitment Date

<sup>22</sup>The term "non-industry" is used in the Transaction Agreement. It is intended to mean someone who is neither a broker or dealer in securities nor affiliated with one. Telephone call between James Duffy, Amex, and Michael Ryan, NASD, and Christine Richardson, Commission, on October 29, 1998.

<sup>23</sup>Amex Committee members will be divided into three classes with staggered three-year terms. No Amex Committee member may serve more than two consecutive three-year terms. Vacancies on the Amex Committee will be filled by a person of the same category as the vacating member. Replacements for Floor Members will be chosen by the Floor Governors on New Amex's Board. Replacement members for other Amex Committee members, including the chairman, will be chosen by a majority of the remaining members of the Amex Committee or, in some circumstances, by action of New Amex's Board (including the approval of at least two Floor Governors of New Amex). All replacements will be subject to the approval of the NASD's Chairman, including Floor Member representatives.

The NASD and Amex have agreed through the undertakings, and have represented to the Commission, that neither the member of the Amex Committee described in Section 9.9(a)(i) of the Transaction Agreement nor any of the non-industry members of the Amex Committee (those described in Section 9.9(a)(v) of the Transaction Agreement) will simultaneously serve on the Board of Governors of either the NASD or New Amex. See Amendment No. 2.

The NASD and Amex also have agreed through the undertakings, and have represented to the Commission, that for the purpose of confirming the SEC's jurisdiction over members of the Amex Committee, such persons will be deemed "directors" as that term is used in Section 3(a)(7), and will be deemed directors of an SRO under Section 19(h)(4), of the Exchange Act.

<sup>24</sup>Promptly after receiving a requested consent in writing from New Amex, the Secretary of Amex Corp. will call a meeting of the holders of the Memberships to vote on the requested consent. If, and only if, the required number of Memberships are voted in favor of authorizing the requested consent, the proper officers of Amex Corp. will promptly grant Amex Corp.'s consent to New Amex. Any requested consent will be granted only upon the affirmative vote of a majority of the Amex Corp. Regular Memberships and the Options Principal Memberships voted (as a single class) at a meeting duly called and convened and at which quorum is present.

<sup>20</sup>The NASD, acting through its Board or a Board representative, will cast the vote of the holder of the Class B Interest for all elected governors, including the four Floor Governors.

<sup>21</sup>The initial Amex Committee Floor Members will be nominated by current Amex floor governors on the Amex Board and agreed to by Amex and the NASD prior to the Closing. The remaining initial members of the Amex Committee will be selected by the NASD and agreed to by the NASD and Amex prior to the Closing. The existence of the Amex Committee will begin on the Closing Date. Five of the seven members of the Amex Committee will constitute a quorum for the transaction of business, and the Committee will act by majority vote.

(approximately six and one-half years after the Closing),<sup>25</sup> New Amex will not make any material market structure change<sup>26</sup> in the equity market without the consent of both Amex Corp. and the Amex Committee. From the fifth anniversary of the Facility Commitment Date until the tenth anniversary of the Closing, New Amex may not make any material market structure changes in the equity market without the consent of the Amex Committee and the Board of New Amex. From and after the tenth anniversary of the Closing, New Amex may not make any material structure change in the new equity market structure without the consent of the Amex Committee; however, an affirmative vote of two-thirds of the entire New Amex Board can override disapproval by the Amex Committee.<sup>27</sup> Similar provisions apply to material market structure changes to the options market.<sup>28</sup> The Amex Committee also has a role in a number of other significant matters, including the acquisition by the NASD of other options or securities exchanges, the timing of the modernization of the New Amex trading facility, and the monitoring of amounts spent on new technology by the NASD for New Amex.<sup>29</sup>

<sup>25</sup> "Facilities Commitment Date" is defined in the Technology Transfer and Development Agreement as the period "[w]ithin six months from the Pilot Program Initiation Date." The "Pilot Program Initiation Date" is defined in the Technology Transfer and Development Agreement as "[b]y the later of nine months from the Closing Date and June 30, 1999."

<sup>26</sup> "Material Market Structure Change" is defined in the Transaction Agreement as "any change or series of changes in the Transaction documents, [New] Amex Constitution, rules or methods of operation of [New] Amex that have the effect of changing in any material way a material element of the new Equity Market structure, as described in Exhibit D, or the Options Market, as existing at the Closing, or in the manner in which a Regular Member or an Options Principal Member is permitted to conduct business in either the new Equity Market structure or the Options Market structure, or the rights or obligations of any such Member in the new Equity Market structure or the Options Market structure. Notwithstanding the foregoing or any other provision herein or in the Exhibits hereto, a change in the market structure specification contained in Exhibit D which, notwithstanding the best efforts of [New Amex and the NASD], is required by the SEC and accepted by the New Amex as described in Section 9.15 [of the Transaction Agreement], shall not be considered a Material Market Structure Change. Any change in the matching procedure (e.g., algorithms) or in the fees provided in Exhibit D shall be deemed a Material Market Structure Change."

<sup>27</sup> See Transaction Agreement, Section 9.10.

<sup>28</sup> See Transaction Agreement, Section 9.11.

<sup>29</sup> New Amex also must give the Floor Members on the Amex Committee at least ten business days' prior notice before aggregate costs and fees to Floor Members and other floor participants on New Amex can be increased by more than ten percent in any calendar year. A majority of those persons may vote to submit the matter to binding arbitration. Such arbitration will last no more than 30 days and will

The principal function of Amex Corp., as limited purpose corporation, will be to implement the voting process to obtain the consents necessary for New Amex to take action. All Amex Corp. Members will have equal voting rights and will vote on certain matters together as a single class.

Although the powers of Amex Corp. are limited, Amex Corp. Members will have certain voting and other rights. Notably, New Amex may increase the number of either Regular and Options Principal Memberships only if such action is consented to by Amex Corp. through a Membership vote. In addition, the right to trade on New Amex will continue to be embodied in Memberships which are interests in Amex Corp., although New Amex will have the authority and responsibility to approve transfers of such Memberships and changes in the "approved persons" of a member or member organization.<sup>30</sup> Amex Corp. Members also will have certain preferential liquidation rights, as set forth in the Transaction Agreement.

### 3. NASD Plan of Responsibility

In File SR-NASD-98-67, the NASD proposed two policies relating to the NASD's responsibilities concerning New Amex and the composition of the Board of Governors of New Amex.<sup>31</sup> Specifically, this proposed rule change sets forth certain principles to guide the NASD in fulfillment of its responsibilities as parent company of New Amex with ultimate responsibility for New Amex's compliance with its statutory responsibilities as a self-regulatory organization ("SRO"). The NASD has represented that it will exercise its powers and its managerial influence to ensure that the New Amex fulfills its self-regulatory obligations by directing New Amex to take action necessary to effectuate its purposes and functions as a national securities exchange operating pursuant to the Act, and ensuring that New Amex has and appropriately allocates such financial, technological, technical, and personnel resources as may be necessary or appropriate to meet its obligations under the Act. Furthermore, the NASD

determine whether the increases were reasonable and fair in light of all relevant factors, including the costs other major securities exchanges charge their Members, the costs historically imposed by New Amex, and changes in the expenses and overall economic performance of New Amex (other than debt service in connection with the \$110 million Development Program).

<sup>30</sup> There are no changes currently proposed to the rules and policies governing the Membership approval process.

<sup>31</sup> See Exchange Act Release No. 40443 (September 16, 1998), 63 FR 51108 (September 24, 1998) (NASD-98-67).

has committed to refraining from taking any action with respect to New Amex that, to the best of its knowledge, would impede, delay, obstruct, or conflict with efforts by New Amex to carry out its self-regulatory obligations under the Act and the rules and regulations thereunder. This filing also provides that the NASD will appoint as one of the two representatives of the NASD staff on the New Amex Board of Governors a person who is not an employee of and has no material business relationship with a broker or dealer or with the NASD, NASD Regulation, Nasdaq or New Amex, but who may be an officer or employee of an issuer of securities listed on Nasdaq or New Amex or traded in the over-the-counter market. The purpose of this change is to ensure compliance with the NASD Delegation Plan, which reflects the requirements of the Commission's Report Pursuant to Section 21(a) of the Act and related order and undertakings, and requires that all boards of NASD subsidiaries equal or exceed 50% non-industry representation in composition.<sup>32</sup>

### D. NASD Corporate Governance

Although NASD Members were not required to vote to approve the merger, NASD Membership approval was required to amend the NASD By-Laws to reflect a term of the Transaction Agreement, requiring the inclusion of the Chief Executive Officer of New Amex and one Floor Governor from the New Amex Board on the NASD Board. File SR-NASD-98-56 reflects this proposed change.<sup>33</sup> Inclusion of these New Amex Members on the NASD Board is designed to provide for

<sup>32</sup> Report and Appendix to Report Pursuant to Section 21(a) of the Exchange Act of 1934 Regarding the NASD and the Nasdaq Stock Market (August 8, 1996) and Exchange Act Release No. 37538 (August 8, 1996) (SEC Order Instituting Public Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions, In the Matter of National Association of Securities Dealers, Inc. Administrative Proceeding File No. 3-9056), respectively. The undertakings were included in the SEC Order. See also Exchange Act Release No. 39326 (November 14, 1997), 62 FR 62385 (November 21, 1997) (File Nos. SR-NASD-97-71, 96-29 and 96-20).

<sup>33</sup> See Exchange Act Release No. 40339 (August 19, 1998), 63 FR 45547 (August 26, 1998) (NASD-98-56). This filing also proposed an additional position on the Board representing an NASD member firm having not more than 150 registered persons. The portion of SR-NASD-98-56 addressing the small firm Board representative was approved in Exchange Act Release No. 40615 (October 28, 1998).

The NASD Membership approved these changes to the NASD By-Laws. Voting on this proposal closed on September 14, 1998. Of the 2,658 ballots received by the NASD, 2,565 were in favor of the By-Law change, 82 opposed the change, and 11 ballots were received with no vote indicated.

representation of New Amex, as a subsidiary of the NASD.

#### E. Class C Trading Rights

The New Amex Constitution also provides for the creation of up to 25 trading rights that will allow holders to specialize in newly listed securities that they are responsible for bringing to New Amex ("Class C Trading Rights"). Class C Trading Rights will have a limited life and will expire on the earlier of three years from the date of issuance or the fifth anniversary of the Closing. These permits are intended to attract firms that are not currently involved in specialist activity on New Amex to bring substantial new listings to New Amex. Accordingly, holders of Class C Trading Rights only will be eligible to be allocated securities that they bring to New Amex, and they may not operate a joint book with a Regular Member.<sup>34</sup> The New Amex Board will determine when and to whom to issue Class C Trading Rights, and the fees, dues and other charges applicable to such rights. Class C Trading Rights will not be transferable except by reason of a business combination, reorganization or other transfer of all or substantially all of the assets from one member organization to another. Class C Trading Rights may be issued to qualified individuals or organizations who are instrumental in obtaining new listings of securities admitted to dealings on New Amex that are judged by New Amex to constitute demonstrable product. New Amex will exercise its judgment in this matter based on both the quantity and quality of listings brought to New Amex.

#### F. Discipline

The New Amex Constitution creates the Amex Adjudicatory Council ("AAC") to review appeals of right from Disciplinary Panel decisions (removing the current Board and Executive Committee review).<sup>35</sup> Modeled on NASD Regulation's National Adjudicatory Council, the AAC will consist of six persons, three of whom

<sup>34</sup> A specialist holding a Class C Trading Right ("Limited Specialist Trading Right") who then becomes a Regular Member will be considered to have continued his registration as a specialist in the securities allocated to him without any need to submit to a further allocation process.

It is anticipated that holders of Class C Trading Rights generally will not be existing Members of Amex Corp; however, the Commission notes that nothing in the New Amex Constitution would preclude current Amex Corp. Members of availing themselves of this provision.

<sup>35</sup> The Commission notes that the current hearing process for Members requiring a hearing before a Disciplinary Panel is not being changed from the current procedures. See New Amex Constitution, Article V, Section .01.

will be New Amex Floor Governors and three of whom will be New Amex Public Governors.<sup>36</sup> AAC members will be nominated by the Amex Nominating Committee or by independent petition signed by at least 25 Members and will be elected by the Regular and Options Principal Members of Amex Corp. voting together as a single class. AAC members will be divided into two classes. The first class (terminating in 1999) will consist of two Floor Governors and one Public Governor. The second class (terminating in 2000) will consist of one Floor Governor and two Public Governors. Apart from the members of the first class whose terms will expire in 1999, AAC members will be elected to two year terms. Beginning with the class elected in 2000, no AAC member may serve more than two consecutive terms unless the member initially is appointed to fill a term of less than one year, in which case the member may serve up to two consecutive terms following the expiration of the initial term.

Respondents in contested disciplinary proceedings can take an appeal of right to the AAC, and any member of the AAC may require the review of a Disciplinary Panel decision by the full AAC.<sup>37</sup> A quorum of the AAC will be four persons. In the event of a tie vote, the decision that is the subject of the review will be upheld. Proposed written decisions of the AAC in contested proceedings are provided to all members of the New Amex Board.

The New Amex Board will have a discretionary right to review decisions of the AAC. Any four members of the New Amex Board may require Board review of an AAC decision. Ten governors will constitute a quorum at a meeting where a decision by the AAC is reviewed and a majority vote of the governors present at the meeting will be required to modify, reverse or remand the decision. In the absence of such discretionary review by the Board, a decision by the AAC will be the final action of New Amex, and therefore appealable to the Commission.

<sup>36</sup> For a description of the National Adjudicatory Council, see Article V of the By-Laws of NASD Regulation.

<sup>37</sup> The AAC may review settlements of disciplinary proceedings that have been approved by a Disciplinary Panel. If the AAC rejects the settlement, the matter would proceed before a Disciplinary Panel as if the settlement had never occurred. The AAC may reject a settlement or impose a lesser penalty upon a respondent; it cannot increase the penalty. AAC decisions to reject a settlement would not be subject to Board review. AAC decisions with respect to settlements (other than rejections) would constitute the final action of New Amex.

#### G. Arbitration

With regard to New Amex's arbitration program, the New Amex Constitution provides that any arbitration filed prior to the Closing will be conducted by means of the arbitration facilities and procedures that existed as of the date the arbitration was instituted. Actions filed following the Closing will be conducted pursuant to the NASD Code of Arbitration Procedure using the arbitration facilities of NASD Regulation, Inc., although an existing Amex provision is preserved allowing use of the New York Stock Exchange arbitration procedures if all parties to the controversy are members there. Certain portions of Amex's arbitration procedures, including that which permits the Board to decline to permit the use of New Amex's arbitration facilities in particular cases, and that which permits arbitration before the American Arbitration Association in certain circumstances, will be deleted in view of the complete assumption by NASD Regulation of New Amex's arbitration program and the adoption of the NASD Code of Arbitration Procedure.

The New Amex Constitution also states that a failure on the part of persons within New Amex's jurisdiction to pay an arbitration award of any exchange or the NASD, shall be deemed a failure to meet his or its engagements and subject him or it to suspension under Article V, Section 3 of the New Amex Constitution.

#### H. Seat Market Program

The Transaction Agreement provides that a Seat Market Program for Regular and Options Principal Memberships will begin immediately after the Closing. This program is intended to moderate possible downside volatility in seat prices following the Closing. The NASD has committed to fund this program, but no "trust" or other segregated fund will be created. Immediately after the Closing, the NASD will commit \$30 million for this program. On January 1, 1999, the NASD will increase its commitment by \$10 million. New Amex will fund this \$10 million increase to the extent that its 1998 earnings allow, and the remainder will be funded by the NASD.<sup>38</sup> The

<sup>38</sup> In addition, the NASD will: (1) increase its commitment by any after-tax net proceeds received from leasing Regular or Options Principal Memberships purchased under the program; (2) increase or decrease its commitment, as the case may be, by the after-tax profit or loss realized from reselling such Memberships; (3) decrease its commitment by the payments or expenditures pursuant to the program (other than payments or

liquidation, dissolution or winding up of New Amex will not affect the NASD's funding commitment under the Seat Market Program.

The Transaction Agreement provides for control of the program by a six-member seat committee (the "Seat Committee"). The Seat Committee will be composed of three Regular or Options Principal Members (at least one who is active on the floor of New Amex and one who is not active on the floor), two Public Members, and the NASD's Chairman (or his designee). The Regular or Options Principal Members on the Seat Committee may not be from large multi-service broker-dealer firms.

The Floor Governors of New Amex will choose the Regular or Options Principal Members to serve on the Seat Committee, and will fill vacancies in those three positions, subject to approval by the NASD Chairman. The other members of the Seat Committee will be chosen, and vacancies filled, by the NASD's Chairman.

During the Seat Market Program, the NASD must purchase Regular and Options Principal Memberships, as and if directed by the Seat Committee. Memberships held or leased by the NASD may not be voted. The NASD may sell or lease Memberships purchased under the program, and net proceeds will be returned to the program.

On or soon after the fifth anniversary of the Closing, the Seat Committee may recommend that the NASD apply up to \$30 million of the funds in the Seat Market Program as: (1) Distributions to Members, (2) reductions in New Amex fees, or (3) investments in technology for New Amex (which will not count toward the \$110 million Development Program). The Seat Committee also may recommend that no fund amounts be spent on any of these choices. Every two years after the fifth anniversary of the closing, the Seat Committee can recommend that the balance of the commitment be applied in one or more of the ways described above.

Each of these Seat Committee recommendations will require the consent of Amex Corp. Upon receiving a Seat Committee recommendation, Amex Corp. must put the matter to a vote of its Members and give its consent if, and only if, authorized by the

expenditures for purchasing Memberships under the program); and (4) increase its commitment by imputed interest at an annual interest rate of five percent on the amount of the commitment, for the first five years after the Closing, and on the difference between the amount of the commitment and the aggregate purchase price of all Memberships purchased under the program during the period they are held by the NASD, after the fifth anniversary of the Closing.

affirmative vote of a majority of the Regular and Options Principal Memberships voted (as a single class) at a meeting called for the purpose of considering the Seat Committee's recommendation. If it receives Amex Corp.'s consent, the NASD must comply with the Seat Committee's recommendation. If the Seat Committee's recommendation is not approved, the Seat Committee must make a new recommendation.<sup>39</sup>

In the case of any vote on the distribution of funds to Members,<sup>40</sup> the Regular and Options Principal Members of Amex Corp. will vote as separate classes on whether to approve the

<sup>39</sup> In *Selma Philipson v. American Stock Exchange, et al.*, 98 Civ 4219 (DC), United States District Court, Southern District of New York, filed as a class action, plaintiff challenged the transaction between the Amex and the NASD on several grounds. The NASD and the Amex have negotiated an agreement in principle for the settlement of this litigation which provides that the Seat Committee shall consider, 18 months and 36 months after the Closing, whether half of the NASD's initial \$30 million commitment to the Member Equity Program should be distributed to owners of Membership interests, used to reduce New Amex fees, or invested in technology for New Amex, rather than continuing to be held for the purchase of seats. After five years, any remaining portion of the initial \$30 million commitment must be used for one of these purposes. In addition, the agreement provides that the NASD shall contribute to a separate fund 15% of any amount by which New Amex's annual after-tax income in each of the first ten years after the Closing exceeds a specified base amount. A committee consisting of three Members of New Amex and the Chairman of the NASD will determine whether this fund shall be distributed to owners of Membership interests, invested in technology for New Amex, or used to fund pension or retirement benefits for owners of Membership interests. The proposed settlement is subject to execution of a formal settlement stipulation, which will then be subject to court approval following notice to all members of the plaintiff class.

It is the view of Amex that, once court approval is received, the terms of the settlement can be implemented without the necessity of further amendment of the Transaction Agreement or any further approval from the Commission. Telephone call between James Duffy, Executive Vice President and General Counsel, Amex, and Michael Walinskas, Deputy Associate Director, Commission, on September 10, 1998.

The Commission notes that this information has been provided to the Commission for informational purposes only. Neither Amex nor the NASD have requested the Commission to approve this in the context of this rule filing or otherwise.

<sup>40</sup> If the Seat Committee's recommendation is other than that funds be distributed to Members, and two or more Floor Governors of New Amex disagree with that recommendation, they may require Amex Corp. to call for a vote of Members. In this case, the Regular and Options Principal Members, voting as a single class, will decide between (i) implementing the Seat Committee's recommendation and (ii) making a cash distribution to Members, in an allocation between Regular and Options Principal Members as proposed by the Seat Committee Floor Members. If two-thirds of the Regular and Options Principal Memberships voted (as a single class) at a meeting called for the purpose of considering the matter approve the distribution, the Seat Committee will direct the NASD to make such distribution.

proposed allocation of the distribution between Regular and Options Principal Members. If either class of Members fails to approve the proposed allocation, the Seat Committee will appoint an arbitrator to decide an equitable allocation between the two classes.

### I. Gratuity Fund

Certain changes are being made in the Constitution with regard to New Amex's Gratuity Fund.<sup>41</sup> Specifically, new language is being added to provide for proportional credits to each participant<sup>42</sup> in reduction of such participant's payments under Article IX in the event the Gratuity Fund receives any extraordinary payment from any source. The Trustees of the Gratuity Fund will be appointed by Amex Corp. following a vote by the Regular and Option Principal Members. This will essentially maintain the current process by which trustees are nominated and elected in the same manner, and at the same time, as governors of Amex. In the event of a vacancy, the Board of Amex Corp. will appoint a person qualified to serve as Trustee until the next meeting at which the Trustees to be appointed are selected. Currently, the Amex Board fills any vacancy, pending the next annual election. These procedures are consistent with procedures in the New By-Laws of Amex Corp. that provide for the election by Members of Amex Corp. of Trustees of the Gratuity Fund, as well as the Amex Nominating Committee, Amex Adjudicatory Council, and nominees for Floor Governors to serve on the New Amex Board.

### J. Miscellaneous Provisions

The transaction also requires that several miscellaneous changes be made to the New Amex Constitution. For example, New Amex Constitution deletes language excepting the Amex Nominating Committee from among the committees that may be dissolved by the New Amex Board. In addition, the New Amex Constitution deletes references to the Executive Committee since New Amex, at least initially, will not have such a committee. The New Amex Constitution provides that the Chief Executive Officer of New Amex, who is the Chairman of the Board, will be elected by a majority of the entire Board. The New Amex Board will have only one Vice Chairman who must be a Floor

<sup>41</sup> For a description of the Gratuity Fund, see New Amex Constitution, Article IX, Section 2.

<sup>42</sup> Participants to the Gratuity Fund include Regular and Options Principal Members, as well as owners, nominees, lessors and lessees of Regular and Options Principal Memberships who satisfy certain eligibility requirements. See New Amex Constitution, Article IX, Section 1(a).

Governor. The New Amex Constitution eliminates the section of the "Selection of General Counsel" in its entirety.

The New Amex Constitution eliminates the New Amex Chairman's status as an ex-officio member of all committees and further clarifies that the Chairman is not a member of certain committees (e.g., the AAC). The New Amex Constitution also provides that the New Amex Chairman is required to call a special meeting of the Board upon the written request of three rather than four governors (reflecting the reduced size of the Board). The Chairman will no longer be permitted to call special meetings of regular members upon the direction of the Board or upon the written request of 50 regular members.<sup>43</sup> The position of "Executive Vice Chairman" is being eliminated as unnecessary.

The New Amex Constitution eliminates in its entirety the section on "Indemnification." Indemnification by New Amex of persons associated with it (e.g., Governors, officers and employees) is covered through the provisions in the LLC Agreement.

The New Amex Constitution also will reduce the number of Regular Memberships from 675 to 661 to reflect the fact that only 661 Regular Memberships currently are outstanding, (675 Memberships had been authorized, but only 661 were issued.)

The New Amex Constitution also will provide that any Regular Member or lessee, by exercising any of the rights inherent in a regular trading right, shall be deemed to have pledged to abide by the New Amex Constitution. A similar provision will be applicable to Options Principal Members or lessees. The purpose of these provisions is to clarify that existing Members will continue to be subject to the jurisdiction of New Amex.

A New Amex Constitution provision concerning "Exchange Liability" will reflect the fact that New Amex provides services as well as facilities to its members.

The New Amex Construction will provide a procedure by which Members may challenge New Amex staff determinations. The appeal procedure will be clarified to eliminate the possibility of a review by a New Amex Disciplinary Panel which properly

should consider only rule violations and not New Amex staff determinations.

The New Amex Constitution provision concerning "fixed income security options trading permits" and "options trading permits" will be deleted in its entirety since both of these classes of trading permits have expired. The provisions regarding Limited Trading Permits ("LTPs") will reduce the maximum number of such permits from 36 to 10 to reflect the fact that there currently are only 10 outstanding.

The New Amex Constitution provision concerning "Fees and Duties" will provide flat rate initiation fee of \$2,500 for Regular and Options Principal Members. This fixed initiation fee replaces the former graduated initiation fee schedule that has become obsolete with the increase in seat prices. (The old formula established a base initiation fee of \$1,000 that increased to a maximum of \$2,500 when seat prices rose above \$20,000.) Certain other additional obsolete provisions also will be deleted from this section.

Furthermore, the New Amex Constitution will make explicit the implicit authority of the New Amex Board to set different charges for different services and securities. Such charges will be subject to filing with, and under certain circumstances approval by, the Commission.

The New Amex Constitution will conform to the current Amex employee trading policy, which allows employees to trade standardized options issued by the Options Clearing Corporation unless such options are on an underlying security listed on the Amex.

The New Amex Constitution will now provide a provision concerning "Authority to Take Action under Emergency or Extraordinary Market Conditions" that will be comparable to Article VII, Section 3 of the NASD's By-Laws. In addition, the Amex Constitution currently references emergency by-laws under Subdivision 17 of Section 12 of the New York State Defense Emergency Act and to the effectiveness of emergency by-laws of New York Corporations. These references will no longer be appropriate to New Amex, as a Delaware Limited Liability Company.

Several necessary changes are being made to Amex Rules 345, 590 and 600 in order to make the rules consistent with the terms of the transaction and the New Amex Constitution.

### III. Summary of Comments

The Commission received one comment letter from Bill T. Singer ("Singer"), who wrote on behalf of the Independent Broker-Dealer Association

("IBDA").<sup>44</sup> The NASD submitted a letter responding to the Singer Letter.<sup>45</sup>

#### A. NASD/Amex Consolidation Issues

Singer is concerned that NASD members were not allowed to vote on the substantive details of the merger and were not given copies of the merger transaction agreement. According to Singer, the ballot submitted to the NASD members did not contain any details about the merger. Instead, the ballot merely asked the members to approve changes to NASD by-laws affecting the composition of the Board of Governors. Singer also contends that the NASD, which did not seek membership approval of the merger, failed to meet the fair representation provision of Section 15A(b)(4) of the Act. Based on this contention, he asks whether the Commission will meet with individual constituencies of NASD members prior to approving the merger. Further, he questions whether the proposed rule change is consistent with the Act because the NASD failed to seek member comments about the merger.

In response, the NASD asserts that whether the merger should be approved by the membership is a matter of state corporate law and the NASD's certificate of incorporation. The NASD states that it is incorporated in Delaware and that the Delaware law does not require the NASD Board to submit the merger to membership approval. Additionally, the NASD maintains that neither the NASD's certificate of incorporation nor its by-laws requires it to submit the merger to membership approval.

The NASD also contends that its members were indirectly given the opportunity to approve the merger through their vote on a change to the NASD's by-laws to add two new Board seats,<sup>46</sup> a change that was necessary for the Closing to occur. According to the NASD, the members overwhelmingly approved the merger with a vote of 2,565 for and 82 against the addition of the new seats.

Additionally, Singer is concerned about the merger's effect on competition between the various markets, noting that the consolidation might increase listing fees for issuers and reduce the NASD's incentive for market innovation. Moreover, after the merger, Singer feels that the NASD might forsake its traditional role as a market for developing companies and an

<sup>44</sup> See *supra* note 8.

<sup>45</sup> See *supra* note 9.

<sup>46</sup> The By-Law change adds two Board positions: one for the Chief Executive Officer of New Amex and one for a Floor Governor from the New Amex Board.

<sup>43</sup> Amex believes that this change is appropriate given that Amex members will no longer be corporate owners of Amex after the Closing. Instead, Holdco and Amex Corp. will be the corporate owners of New Amex. Any meeting of Members will be conducted under the By-Laws of Amex Corp. in the circumstances specified therein and would not be governed by the New Amex Constitution.

association of independent/regional members.

In response, the NASD believes that the combination of the two markets will provide a more efficient mechanism for trading at lower costs. Furthermore, the NASD notes that the Antitrust Division of the Department of Justice reviewed the transaction for anticompetitive effects, and did not object. In sum, the NASD believes these benefits will improve the markets for investors, issuers, and NASD members.

Singer also asserts that the proposed operation of New Amex as an independent subsidiary poses significant issues. First, he maintains that the independent operation of New Amex might result in a loss of economy of scale and entail additional costs. The NASD, however, believes that the application of its modern technology to the New Amex market facilities will provide significant scale economies and result in cost savings for investors and traders. Second, Singer is concerned about how the NASD will decide between Nasdaq or New Amex when allocating listings. He also feels that issuers who would normally list on Nasdaq might choose New Amex instead. According to Singer, this choice could reduce the trading revenue of NASD market makers.

The NASD responds by asserting that, after the merger, NASD market makers will have greater access to the two markets at lower costs. The NASD also believes the creation of multiple market venues will provide market choices for issuers and additional business opportunities for NASD member firms who underwrite securities.

#### *B. Financing the Merger*

Singer notes that the NASD does not explain how it will finance the \$30 million seat stabilization program. He believes that the money might be better spent on the improvement of NASD technology or the hiring of additional NASD employees. Furthermore, Singer observes that the NASD does not explain how it will finance the upgrade of Amex's technology. In both the seat stabilization plan and the technology upgrade, Singer fears that the NASD will assess its members with the costs. He believes that, although all NASD members will shoulder the burden of transferring resources to New Amex, most members will not receive anything in return.

The NASD responds by maintaining that its Board, after careful consideration of the transaction, found that the transaction was fair to the Association and in the best interests of its members. Moreover, the NASD

contends that the money spent on upgrading Amex's technology will benefit all of the NASD's members, and that the increased technological capabilities will reduce costs for members trading on both the Nasdaq and Amex markets.

In addition, Singer suggests that the prior improper conduct of major Nasdaq market-makers might have contributed to the weakening of the Amex market. If this weakening did occur, then Singer believes that the major Nasdaq market-makers should bear the cost of the merger.

#### *C. Regulatory and Other Concerns*

Singer suggests that independent/regional members recently have experienced difficulties in securing permission to make markets in or to underwrite OTC Bulletin Board or Nasdaq Small Capitalization Issues. Because of these difficulties, Singer asks whether new NASD and Commission regulatory initiatives will further restrict these members' abilities to facilitate transactions in smaller capitalization issues. Singer also raises other general concerns about the merger.<sup>47</sup>

#### **IV. Discussion**

The Commission believes that Amex's proposed rule changes are consistent with Section 6(b)(3), 6(b)(5), and 6(b)(8) of the Act in that they are designed to assure a fair representation of an exchange's 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 the exchange, broker, or dealer; 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 mechanisms of a free and open market and a national market system, and, in general, to protect investors and the public interest; and do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

The Commission also finds that the NASD's proposed rule changes are

<sup>47</sup> For example, Singer expresses concern about the recent exodus of senior Commission staff to the NASD, Nasdaq market makers, and private firms. He feels that these groups might have greater access to the Commission and the merger approval process because of their ties with the Commission. Singer also notes that NASD Chairman Frank Zarb and Chairman Levitt were former business partners.

consistent with Sections 15A(b)(6) and 15A(b)(9) of the Act in that they are 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 mechanisms of a free and open market and a national market system, and, in general, to protect investors and the public interest; and do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.<sup>48</sup>

The proposed merger offers the promise of important benefits to the public. Specifically, the merger should help improve the competitiveness of New Amex's auction market by making it a more efficient, technologically advanced alternative to other exchange auction markets. This technological advance should increase competition between existing markets to improve their marketplaces in order to be able to offer the best available market trading mechanisms at the lowest cost. Of particular note, the proposed future introduction of a new electronic limit order book providing automatic execution for electronically delivered orders may offer a more efficient and lower-cost auction market for Amex equities.

The Commission disagrees with the argument made by the commenter that the merger is likely to have anticompetitive effects, particularly the possibility of higher listing fees for issuers and a reduced incentive for NASD market innovation. The Commission does not believe that listing fees were a primary form of competition between Amex and Nasdaq in the past; rather, competition focused on market structures, quality of executions and services. These alternative choices still remain between Nasdaq and Amex. Moreover, New Amex would need to file any proposed fee increases with the SEC pursuant to a rule filing that must meet the requirements of the Act. With regard to a possible reduction in market innovation, the Commission believes that the competition presented by the New York Stock Exchange and the regional exchanges provides a more than adequate incentive for the NASD and New Amex to each continue finding ways to create better markets. Moreover,

<sup>48</sup> In approving this rule, the Commission notes that it has considered the proposed rules' impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).



the Commission emphasizes that the initial combination between the NASD and Amex will not result in the closure of any equity or options markets. Indeed, it is expected that New Amex and Nasdaq will remain as separate markets and each will retain their separate listings and offer different market features. The Commission notes that the transaction will not result in a combination of the Amex equity and options floors and Nasdaq, but rather results in a change of ownership of Amex. The basic market structure of Amex and Nasdaq will remain unchanged.

In addition to increased competition, the Commission observes that the proposal should help improve both the Amex and NASD marketplaces by combining the strengths of the two organizations, to the benefit of the markets and investors. Under the terms of the transaction, Amex will receive an infusion of new capital that will allow it to upgrade its trading facilities and technology. This should enable Amex to increase its trading capabilities, and remain competitive with other auction-based equity and option markets, possibly attracting new listings and increasing volume. The Commission also believes that the NASD, by gaining control of an established options exchange and a specialist-based auction market that complements Nasdaq, its dealer-based equity market, will be able to offer issues and investors greater choice in where to list and where to invest.

#### A. Transfer of Section 6 Registration

As a general matter, the Commission does not view registration as a national securities exchange under the Act as an asset that is freely transferable or that can be bought and sold. Based on the unique facts and circumstances presented by this proposal, however, the Commission believes it is reasonable under, and consistent with, the Act for Amex effectively to transfer its Section 6 exchange registration to New Amex. The Commission notes that, except for the changes currently proposed to the Amex Constitution and Rules, the Constitution and Rules of New Amex will remain unchanged from those of existing Amex. In addition, the Amex Corp. Members will be the same as the current Amex Members, and the operation of the floor of the exchange will remain unchanged. If New Amex were not permitted to, in effect, succeed to the registration of Amex, it would have been forced to undertake the full process of reregistering, including refiling its entire Constitution, its By-Laws and Certificate of Incorporation, as

well as all of its current Rules. In addition, New Amex would have had to submit a complete explanation of New Amex and its operations, its listing and membership forms and requirements, consolidated and unconsolidated financial statements, a list of all members and member organizations, and a list of all the securities listed on New Amex or traded pursuant to unlisted trading privileges. This process would have added little of value to the review previously given to these matters in filings made under Section 19 of the Act and Rule 19b-4 thereunder. The 19b-4 rule filing process has afforded essentially the same opportunity for public notice and comment and Commission review as would have been provided by a New Amex application for exchange registration. Accordingly, on the facts presented here, the Commission has not required Amex to deregister as a national securities exchange and New Amex to file an application for exchange registration.

#### B. Corporate Structure—Regulation of New Amex and Amex Corp. Members

The Commission believes that the framework of the proposal provides for sufficient regulatory oversight of Amex Corp. Members and the operation of New Amex as an SRO, as required by the Act. The Commission notes that New Amex, as a registered SRO under Section 6 of the Act, will have the statutory authority and responsibility to, among other things, discipline its Members, amend its Constitution and Rules (subject to the consent of the NASD, the parent company), list and delist securities, and grant or deny Membership in New Amex.<sup>49</sup>

The Commission notes that Amex Corp. Members are subject to the jurisdiction of New Amex through the provisions of the New Amex Constitution. Members (both Regular and Options Principal) are defined in the New Amex Constitution as those persons holding trading rights issued by Amex Corp. which grant them the right to transact business on the floor of New Amex. The New Amex Constitution states that by exercising the trading rights on the floor of New Amex, both the Amex Corp. Regular and Options Principal members have pledged to

<sup>49</sup> The Commission notes that the present filing is silent as to whether it is the intention of the NASD and New Amex to consolidate SRO functions. A consolidation of SRO functions potentially raises important issues under the Exchange Act. The Commission notes that if Amex were to propose any changes to consolidate its SRO functions and have them performed by the NASD (or any other party) it should notify the Commission prior to implementing such change, so that the Commission may determine if a rule filing is necessary.

abide by the New Amex Constitution and all the rules and regulations (or orders, directives or decisions) adopted pursuant to the New Amex Constitution.

#### C. NASD Ownership and Responsibility

The Commission believes that the proposal adequately addresses the role of the NASD, as the parent corporation, in the operation of New Amex. Particularly, the Commission finds it critical to the proposal that the NASD, as the parent company with a controlling interest in New Amex, has committed to ensuring that New Amex meets its obligations as an SRO. It has been represented that the NASD will bear ultimate responsibility to ensure that New Amex meets its statutory obligations and that the necessary and appropriate resources are available to New Amex so that it can meet the evolving demands of operating a regulatory and compliance program in an advanced marketplace.<sup>50</sup> The acceptance of this responsibility is entirely appropriate given the management and financial control held by the NASD as a result of the terms of the merger. In order to codify this responsibility, the NASD submitted a filing which states that the NASD, as the parent company of New Amex, will be responsible to ensure that New Amex meets its obligations as a self-regulatory organization. It will be the policy of the NASD that in discharging this responsibility the NASD will be governed by the following principles: The NASD will exercise its powers and its managerial influence to ensure that New Amex fulfills its self-regulatory obligations by directing New Amex to take action necessary to effectuate its purposes and functions as a national securities exchange operating pursuant to the Act, and ensuring that New Amex has and appropriately allocates such financial, technological, technical, and personnel resources as may be necessary or appropriate to meet its obligations under the Act. Finally, the NASD has also committed to refrain from taking any action with respect to New Amex that, to the best of its knowledge, would impede, delay, obstruct, or conflict with efforts by New Amex to carry out its SRO obligations under the Act, and the rules and regulations thereunder. The Commission believes it is reasonable and consistent with the Act for the NASD, as parent company and controlling owner, to make these commitments. Indeed, the adoption of this policy statement, which shall constitute a rule of a self-regulatory

<sup>50</sup> See Transaction Documents, Information Memorandum, pp. 14 and 40.

organization under the Act enforceable by the Commission pursuant to Section 19 of the Act, is a necessary component to the Commission's determination that the submitted proposals are consistent with the Act.

#### D. New Amex Corporate Governance

The requirement of Section 6(b)(3) of the Act that the rules of an exchange assure a 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 is designed to ensure in a traditional exchange structure that a member has a voice in the use of self-regulatory authority that may affect the member. This requirement, among other things, also helps ensure that the member's financial stake in its seat and the structure of the market is considered in the decisions of the exchange, and it protects members from unfair, unfettered disciplinary actions under the rules of the exchange. Although the terms of the merger provide the NASD with ultimate control over New Amex, the merger has been structured to satisfy the principles of fair representation in several ways.

#### 1. New Amex Board Composition

The Commission believes that the composition of the New Amex Board of Governors ("New Amex Board") is consistent with Section 6(b)(3) of the Act in that it provides for fair representation of its members in the selection of its directors and administration of its affairs and provides 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. First, nine of the eighteen New Amex Board members are "public" representatives who are not affiliated with the securities industry, and no more than three of these nine non-industry governors may serve on both the New Amex and NASD Boards.<sup>51</sup> Second, the proposed New Amex Constitution provides the Amex Corp. Membership the opportunity to select member representatives on the New Amex Board by granting Amex Corp. The authority to nominate the four New Amex Board members that are Floor Governors, one of whom must be an equity specialist and one whom must be

an ROT. Floor Governor nominees would be proposed by either the Amex Nominating Committee (consisting of three Floor Members and two Public Members) or a petition signed by 25 Members and would be selected by a plurality of the Amex Corp. Regular and Options Principal members voting together as a single class. The Amex Corp. Membership elects the members of the Amex Nominating Committee, which is an Amex Corp. committee under the By-Laws of Amex Corp.<sup>52</sup> The Commission believes that these nominating procedures for Member representatives on the New Amex Board should help ensure that the diverse interests of Floor Members are represented. The Commission notes that even though the NASD must approve the Floor Governors, it can reject the nominees only on specific regulatory grounds.<sup>53</sup> In addition, the proposed rule change provides that the Vice Chairman of the New Amex Board must be a Floor Governor. The Commission also believes it is appropriate for the New Amex Board members to be divided into classes to ensure that the terms of all the Floor Governor New Amex Board members and the public New Amex Board members do not expire at one time, and for New Amex to establish limits on the number of consecutive terms a New Amex Board member can serve.

Additionally, the Commission believes that inclusion of one New Amex Floor Governor and the Chief Executive Officer of New Amex on the NASD on the NASD Board as representatives of New Amex helps fulfill the fair representation requirements of the Act on the part of New Amex. The New Amex Floor Governor is nominated by the Amex Corp. Membership and will be able to most directly express their viewpoint and concerns within the NASD Board forum. In addition, the Chief Executive Officer of New Amex will be able to provide information about, and communicate the needs of, New Amex to the NASD Board.

<sup>52</sup> In addition, the members of the Amex Nominating Committee are also divided into two classes, with a public member in each class, whose terms expire at different times. Persons on the Amex Nominating Committee cannot serve consecutive terms and no one affiliated with a member of the Amex Nominating Committee can be eligible as a candidate for a ticket named by it.

<sup>53</sup> The NASD can reject the Floor Governor nominee only if the nominee is (1) subject to a statutory disqualification, or (2) subject to a proceeding or investigation which could result in a statutory disqualification, or (3) has been disciplined by a securities SRO with respect to a matter involving fraud or a serious violation of U.S. securities laws.

Under the proposed corporate structure, there is the potential for members of the boards of the NASD or one of its other subsidiaries and New Amex to overlap. The Commission believes that such overlap presents potential conflicts. Conflicts could occur notwithstanding that each Board member must vote in the best interests of the entity on whose board he or she is sitting at that time. For example, a dual Board member could be asked to vote on whether or not to allocate money to New Amex operations. As a New Amex Board member, he or she could conclude that it is in the best interest of New Amex to allocate the funds. However, as a NASD Board member, he or she could conclude that the money would be better spent on the NASD, or Nasdaq. The Commission believes that the limitation of three non-industry board members who can serve on both the NASD Board and the New Amex Board, coupled with New Amex's assertion that it will implement conflict of interest policies and procedures to address potential unique issues facing governors serving on both boards, adequately addresses the issue.

#### 2. Protection of Amex Membership Interests

The Commission believes that the proposal provides for fair representation and participation of the various types of Amex Corp. Members in the governance and operation of New Amex. Although the NASD has majority control over New Amex, several important structures are provided to better ensure that the interests of Amex Corp. Members are adequately represented in the critical decisions regarding New Amex. This is accomplished by requiring consent of either Amex Corp. (through a Membership vote), the Amex Committee, or both, in situations impacting certain Membership interests or material changes to New Amex, as described above in Section II.C.2. Additionally, the Commission believes that even after the expiration of the express limits on changes to the New Amex structure, the authority exercised by the Amex Committee provides on an ongoing basis for significant member and public input, representation, and participation in the operation of the equity and options markets and the development of new trading facilities on New Amex. The Commission notes that no member of the Amex Committee designated as either a non-industry member or an "upstairs" member may overlap with the NASD or New Amex Boards. The Commission believes that this limitation is appropriate to help avoid potential conflicts of interest for

<sup>51</sup> Eight public governors are nominated by the NASD Nominating Committee, and one of the two NASD representatives on the New Amex Board is a person that meets the qualifications of Non-Industry Governor as defined under NASD rules.

Amex Committee members in the exercise of their duties and to preserve their independence. The Commission believes that the Amex Committee should adequately represent the interests of Amex Corp. members as it exercises its specific powers.

The Commission believes it is appropriate for the Amex Corp. members, through the Amex Committee, to have a vote in contemplated changes to the basic structure and operation of Amex's equity and options trading floors, including the amount of money spent by the NASD to upgrade the technology used on the floor, as well as certain increases in member fees, because these areas affect the operation of the trading floor and financial burdens imposed on the Amex Corp. Membership. The Commission also believes that it is important for Amex Corp. Members to have a degree of control over the areas of new memberships, changes to the basic market structure, and amendments to the New Amex LLC agreement because they implicate the value of member seats and member's trading rights on the Amex floor, as well as New Amex's authority as contained in the LLC agreement. Without these powers, New Amex and the NASD would have the authority to take steps to dilute Amex Corp. Memberships and restructure the basic trading structure on the equity and options floors, and Amex Corp. members would have little influence over the imposition of fees upon themselves.

Although the Commission recognizes the need for the Amex Committee, it also believes that the Amex Committee will be performing certain functions similar to those performed by the board of New Amex, a registered self-regulatory organization. For example, the Amex Committee has the right to review and veto changes to the structure and operation of Amex's equity and option trading floor, as well as any changes that would implicate the value of member seats and member trading rights. Because the Amex Committee will be performing important functions with respect to the board of an SRO, as a material condition to this order of approval the Commission is deeming the members of the Amex Committee to be "director[s] of [a] self-regulatory organization" for purposes of Commission oversight. Exchange Act Section 19(h)(4).<sup>54</sup>

<sup>54</sup> See also Exchange Act Section 3(a)(7) ("The term 'director' means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated."). The joint letter from the NASD and Amex, dated October 29, 1998, amending the Amex rule filing acknowledges and

### 3. Disciplinary Process

The Commission believes that proposed rule changes to the disciplinary process for New Amex are consistent with the requirement of Section 6(b)(7) of the Act that the rules of an exchange provide a fair procedure for the disciplining of members and persons associated with members because the process, as proposed, provides for review of all disciplinary matters by a committee composed of both Amex Corp. Members and public representatives. The Commission notes in particular that the AAC, which is empowered to act for the full New Amex Board in reviewing appeals from disciplinary proceedings, is composed of three Public Members and three Floor Governors, all of whom are nominated by the Amex Nominating Committee (or by petition signed by twenty-five Members) and elected by a full Amex Corp. Membership vote. In addition, all respondents in contested disciplinary proceedings have the right to appeal the decision of a Disciplinary Panel to the AAC, and all decisions of the AAC are appealable to the Commission (or by the full New Amex Board, if at least four Governors desire such review).

### E. Seat Market Program

The Commission believes that the Seat Market Program, run by the Seat Committee, is a reasonable means to help protect the value of Amex Corp. Member seats from any downside volatility that may occur as a result of the merger.<sup>55</sup> The Seat Program may help protect the value of member seats by authorizing the NASD, upon a recommendation from the NASD Seat Committee, to buy Memberships. In addition, the Seat Market Program also provides additional monetary benefits for Amex Corp. Members in that the Seat Committee may recommend that the NASD apply the Seat Program funds to reduce fees, invest in technology for New Amex, or distribute the funds to

accepts the Commission's interpretation: "For the purpose of confirming the SEC's jurisdiction over such persons, the members of the Amex Committee shall be deemed 'directors' as that term is used in section 3(a)(7), and shall be deemed directors of a self-regulatory organization under Section 19(h)(4), of the Exchange Act."

<sup>55</sup> The Seat Committee is composed of three members (at least one who is active on the New Amex floor and one who is not, none of whom can be from multi-service broker-dealer firms), two Public Members and the NASD's Chairman. The initial and replacement Regular and Options Principal Members will be chosen by the floor governors on the New Amex Board and must be approved by the NASD's Chairman. The remaining initial and replacement members will be chosen by the NASD's Chairman.

Members.<sup>56</sup> A Seat Committee recommendation that is approved by a majority vote of all Amex Corp. Members voting as a single class must be complied with by the NASD.

### F. Class C Trading Rights

The Commission believes that the creation of Class C Trading Rights is reasonable in that it may serve to encourage new firms to bring new listings to New Amex without having to become full Members. The Commission believes that the creation of Class C Trading Rights should not harm the value of full Membership seats because they are of limited duration (expiring on the earlier of three years from the date of issuance or the fifth anniversary of the closing), are limited in number (25), and the owner of the right is not allowed to operate a joint book with a regular member. The Commission notes that any person holding a Class C Trading right would still be bound by New Amex Rules relating to the obligations of and restrictions on specialists, including Rule 190 regulating specialist relationships with the issuer of a stock in which that specialist is registered and Rule 170 and procedures adopted thereunder for the evaluation of specialist performance and imposition of non-disciplinary sanctions, including reallocations for unsatisfactory performance.

### G. NASD Compliance With the Act and Its Rules

In response to the commenter's concern that the members of the NASD neither received any detailed information on the terms of the transaction nor had the opportunity to approve or disapprove the substance of the transaction, the NASD represented that it followed proper corporate governance procedure in approving the transaction and was not required to submit the transaction to a full NASD membership vote. The Commission believes there was adequate notice and opportunity for comment on the substance of the current proposals because the Commission published the substance and terms of each of the three proposals for the full notice and comment period. The request for comments was highlighted on the Commission's website,<sup>57</sup> and was published in the **Federal Register**. The NASD Board, which has the authority to approve the transaction on behalf of its members, determined that the

<sup>56</sup> The Seat Committee can also recommend that no money be spent at a particular time.

<sup>57</sup> See [www.sec.gov](http://www.sec.gov).

transaction was fair to the NASD and in the best interests of its members.<sup>58</sup>

#### H. Miscellaneous

The Commission believes that it is consistent with the Act to amend the language of Article IX, Section 10 of the New Amex Constitution to provide specifically for the appointment of Trustees of the Gratuity Fund by the Amex Corp. Membership. Currently, the Trustees are appointed by the Amex membership, but the wording of Article IX, Section 10, which states that they are appointed in the same manner as the Amex governors, will not remain the same under the proposal. The Commission also believes it is reasonable to provide that the Amex Corp. Board will appoint interim replacement Trustees, rather than the New Amex Board, in order to allow for member input. Additionally, the Commission believes it is consistent with the Act to provide that in the event of an extraordinary payment received by the Gratuity Fund, a proportion of such payment shall be credited to each participant in reduction of his or her payments under the Gratuity Fund.

The Commission believes that the proposed rule change eliminating Amex's arbitration program and referring cases to the NASD is consistent with the Act because it will maintain a fair arbitration forum available for all Amex arbitration claims, despite Amex's small caseload, which may not sustain an independent program. Merging the Amex program with the NASD arbitration program, the industry's largest, takes advantage of economies of scale. The Commission also believes that procedurally the proposed rule change should adequately ensure that all arbitration cases that would be subject to Amex's arbitration process will be provided for under the NASD's arbitration program. The proposed rule change also provides for adequate enforcement in that any violation of the NASD's Code of Arbitration Procedure by Amex Corp.

<sup>58</sup> In response to the commenter's concern over the NASD's financial commitments under the transaction, the Commission notes that such commitments were given in consideration of the acquisition of a controlling interest in New Amex. The Commission also notes that the NASD's Board determined that the transaction is fair and in the best interests of its members based upon an independent assessment of the fairness of the transaction to the NASD. Finally, the Commission notes that the NASD represents that it plans to allocate sufficient resources to upgrade its technological capabilities in order to provide investors with the fastest, fairest and least expensive marketplace access on a global scale, and that this will be accomplished within the context of the transaction, which will benefit all of its members, large or small.

Members would be considered a violation of New Amex rules, subjecting the violator to New Amex disciplinary action.

The Commission believes that it is consistent with the Act to amend Section 1(e) of Article IV of the New Amex Constitution relating to New Amex liability to reflect the fact that New Amex provides services as well as facilities to its members. The Commission notes that it approved a similar change to the Chicago Board Options Exchange ("CBOE") liability provisions.<sup>59</sup> The Commission also believes it is reasonable for Amex to delete Article II, Section 5 of the Constitution, Indemnification, because the LLC Agreement provides for indemnification of the persons associated with New Amex.

The Commission believes that the amendment to Article VII, Section 1 of the New Amex Constitution to revise member fees is consistent with Section 6(b)(4) of the Act in that it provides for the equitable allocation of reasonable fees among its members. The amendment provides a flat rate initiation fee of \$2,500 for Regular and Options Principal Members, replacing the former graduated initiation fee schedule that Amex believes has become obsolete with the increase in seat prices. The Commission also believes it is consistent with Section 6(b)(4) of the Act to codify existing practice by granting the New Amex Board the authority to set different rates for equity or options transactions effected in different securities or through different mechanisms.

The Commission believes it is consistent with the Act to amend the Amex employee option trading policy to reflect the policy that Amex employees can trade standardized options issued by the Options Clearing Corporation, unless such option is on an underlying security listed on Amex. The Commission also believes it is reasonable for Amex to delete current Article XII, relating to an emergency committee that has authority to act in emergency situations, in its entirety and to replace it with an emergency provision comparable to Article VII, Section 3 of the NASD's By-Laws. The provisions of the current Article XII state that they constitute emergency by-laws under the New York State Defense Emergency Act, which Amex states will no longer be applicable because New Amex is an LLC incorporated under Delaware Law, not New York law. In addition, the Commission believes that new Article XII provides an adequate

<sup>59</sup> See CBOE rule 6.7(a).

procedure for New Amex operations in the case of emergencies or extraordinary market conditions.<sup>60</sup>

The proposed rule change makes several other miscellaneous amendments to the New Amex Constitution and Rules that are dictated by the Transaction Documents. The Commission believes that these changes, which are extremely technical in nature, are reasonable in that they generally are nonsubstantive or address particular corporate governance requirements that are necessary in order to make the New Amex Constitution and Rules consistent with the new proposed governance structure.

No provision contained in the Transaction Documents or in any other agreement or document, nor any actions taken pursuant to them, shall be construed to affect, or shall affect, any right or responsibility of the Commission to take any action under the Federal Securities Laws. This includes, but is not limited to, the Commission's rights and responsibilities under Section 19 of the Act (i) to review and approve rule changes by an SRO, as those terms are defined under the Act and interpreted by the Commission; (ii) to take appropriate disciplinary action against an SRO or its officers and directors; or (iii) to amend the rules of an SRO. The Commission's approval of the rule changes necessary for the consummation of the merger of the NASD and Amex is expressly conditioned on this statement.

The Commission finds good cause to approve Amendment No. 2 to SR-Amex-98-32 prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Specifically, Amendment No. 2 clarifies and strengthens the proposed rule change in that it limits the number of overlapping public and non-industry governors on the NASD and New Amex Boards, and restricts the non-industry and upstairs members of the Amex Committee from also serving on the NASD or New Amex Boards, thereby furthering the independence of these bodies. Additionally, Amendment No. 2 provides that New Amex will implement conflict of interest policies and procedures to address any potential issues facing overlapping members on

<sup>60</sup> The new Article XII provides that in the event of an emergency or extraordinary market conditions the New Amex Board (or such person or persons as the Board designates) shall have the authority to take action regarding the trading of securities on the Exchange and the operation of any Exchange trading system or facility, if the Board decides that the action is necessary or appropriate to protect investors or the public interest or for the orderly operation of the Exchange or any Exchange system or facility.

the NASD and New Amex Boards. This provision will serve to help New Amex comply with the requirements of the Act. Finally, Amendment No. 2 strengthens the proposed rule change by addressing the Commission's jurisdiction over Amex Committee members. Accordingly, the Commission believes that it is consistent with Section 6(b)(5) of the Act to approve Amendment No. 2 to the proposal on an accelerated basis.

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2 to SR-Amex-98-32, including whether Amendment No. 2 is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. 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 at 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 submissions should refer to File No. SR-Amex-98-32 and should be submitted by November 27, 1998.

## V. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>61</sup> that the proposed rule changes (SR-Amex-98-32; SR-NASD-98-56; SR-NASD-98-67) are approved, as amended.

By the Commission.

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40623; File No. SR-GSCC-98-02]

### Self-Regulatory Organizations; Government Securities Clearing Corporation; Order Approving a Proposed Rule Change Regarding the Implementation of the GCF Repo Service

October 30, 1998.

On April 10, 1998, the Government Securities Clearing Corporation ("GSCC") filed with the Securities and Exchange Commission ("Commission") a proposed rule change (File No. SR-GSCC-98-02) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>1</sup> Notice of the proposal was published in the **Federal Register** on June 9, 1998.<sup>2</sup> The Commission received six comment letters from five commenters in response to the proposed rule change.<sup>3</sup> For the reasons discussed below, the Commission is approving the proposed rule change.

#### I. Description

Under the proposed rule change, GSCC will implement a new service called the GCF Repo service. The GCF Repo service will allow GSCC's dealer members to trade general collateral repos involving U.S. Government securities throughout the day without requiring intraday, trade for trade settlement on a delivery versus payment ("DVP") basis.

#### A. General Description of the GCF Repo Service

The GCF Repo service will enable netting members of GSCC that are not interdealer brokers ("dealers") to trade general collateral repos, based on rate and term, with interdealer broker netting members of GSCC ("brokers") on a blind basis throughout each day. Brokers will be required to submit GCF Repo trade data to GSCC within five minutes of trade execution through a new terminal function. Brokers will not be able to submit GCF Repo trades in batch. Upon receipt of the trade data, GSCC immediately will report transaction details to dealers through a terminal facility, and the GCF Repos will receive GSCC's settlement guarantee. Standardized, generic CUSIP numbers established exclusively for the GCF Repo service will be used to specify the acceptable type of

underlying eligible collateral, which will include Treasuries, Agencies, and mortgage-backed securities.<sup>4</sup>

The daily cutoff for submission of trades through the GCF Repo service will be five minutes after a predetermined trading deadline, which initially will be 3:30 p.m. GSCC will reject all trades submitted for same day processing that are received after the cutoff. Dealers initially will have until 3:45 p.m. to affirm or disaffirm trade data submitted against them by a broker. If a dealer takes no action either to affirm or to disaffirm trade data, the trade automatically will be deemed to be affirmed. GSCC will then conduct an afternoon net exclusively for GCF Repo service activity and will establish a single net receive or deliver obligation for each dealer in each generic CUSIP.

Each dealer with a net deliver obligation will allocate acceptable securities (determined by the generic CUSIP) and will deliver those securities on a DVP basis to a GSCC account within the dealer's clearing bank using a modified triparty arrangement. GSCC will then instruct the clearing bank to deliver those securities to dealers that have net receive obligations. All GCF Repo service activity will settle between dealers and GSCC within the dealers' clearing banks.

GSCC initially will implement the GCF Repo service within each of its participating clearing banks separately.<sup>5</sup> As a result, a participating dealer will be able to trade GCF Repos only with other dealers that use the same clearing bank.<sup>6</sup>

#### B. Participant Eligibility

To be eligible for the GCF Repo service, brokers and dealers will be required to meet the qualifications for

<sup>4</sup> The specific collateral will not be known at the time of the trade. As a result, brokers will submit all GCF Repo trades to GSCC using generic general collateral CUSIPs that denote the underlying category of security. GSCC expects that the initial types of generic CUSIPs that will be used for GCF Repo activity will denote the following categories of securities: all Treasury securities, Treasury securities with a remaining maturity of ten years and under, all Fedwire-eligible Agency securities, and all Fedwire-eligible mortgage-backed securities.

<sup>5</sup> Currently, GSCC's clearing banks are the Bank of New York and the Chase Manhattan Bank. Under the proposed rule change, any clearing bank that meets GSCC's operational requirements will be able to provide GCF Repo settlement services to GSCC netting members.

<sup>6</sup> GSCC has informed the Commission that it eventually would like to expand the GCF Repo service to allow dealers to engage in GCF Repo trading with dealers that use different clearing banks. As a result, GSCC currently is engaged in discussions with staff of the Federal Reserve Bank of New York regarding the means by which to accomplish "after-hours" interbank securities allocations. A resolution of the issues involved may require, among other things, opening of the securities Fedwire after its normal close.

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

<sup>2</sup> Securities Exchange Act Release No. 40057 (June 2, 1998), 63 FR 31539.

<sup>3</sup> *Infra* note 12.

<sup>61</sup> 15 U.S.C. 78s(b)(2).