

Exchange is not proposing any significant changes to its existing operational and trading structure in connection with the Demutualization. Also, the Demutualization will not affect the functions of the Exchange as a self-regulatory organization ("SRO") and will not affect the designation of the Exchange as "designated examining authority" ("DEA") for the Member Organizations for which the Exchange is the DEA today. In particular, the Exchange is not proposing to make any changes to the existing disciplinary system, fines or the related appellate process in connection with the Plan of Demutualization.¹²

The Exchange proposes to effect the Plan of Demutualization and the Proposed Rule Change for the following reasons: (i) The Phlx is facing significant financial challenges, and without the Demutualization the Phlx's viability in its current operating structure is questionable; (ii) without the Demutualization, the Phlx will be limited, to a large degree, to its current base of Members and Owners as a source of capital and revenue; (iii) the Demutualization of the Phlx will potentially facilitate the Exchange's ability to enter into relationships with strategic or financial partners who may be crucial for the Exchange's future development, capital formation and viability; (iv) the new permit structure may facilitate the introduction of new products on the Exchange and will potentially increase transaction volume and Exchange revenues; and (v) a demutualized Exchange will be better positioned to react to new opportunities and challenges.

In addition to those portions of the Proposed Rule Change which relate directly or indirectly to the Plan of Demutualization, described below under "Summary of Demutualization—Related Changes," the Exchange is also proposing certain other revisions to the By-laws and the Rules as part of the Proposed Rule Change, which are primarily related to the deletion of outdated or otherwise obsolete provisions in the By-laws and Rules, including changes required to conform the By-laws to requirements under the Act. These changes are summarized below under "Summary of Non-Demutualization-Related Changes."

¹² Separately, the Exchange intends to file a proposed rule change to adopt fees applicable to Series A-1 Permits and to make conforming changes to its fee schedule as a result of the Demutualization. Accordingly, the Merger Agreement provides that the effectiveness of the Merger (and thus the Plan of Demutualization in general) will be, *inter alia*, conditioned upon such filing becoming effective or being approved by the Commission, as the case may be.

i. Summary of Demutualization-Related Changes

The following summarizes the proposed material changes to the Certificate of Incorporation, the By-laws and the Rules (collectively, the "Governing Documents") of the Exchange in connection with the Plan of Demutualization:

A. Capital Structure of the Demutualized Phlx

Changes to the capital structure of the Phlx, as set forth in Article FOURTH of the proposed Certificate of Incorporation, generally reflect the proposed conversion of the Phlx from a non-stock Delaware corporation to a demutualized Delaware stock corporation. As discussed in greater detail below, the single share of the Series A Preferred Stock, issued to the Trust governed by the Trust Agreement, is designed to facilitate the exercise by Members and Member Organizations of their rights to fair representation in the selection and removal of On-Floor Governors of the Exchange and to facilitate the administration of the affairs of the Exchange in accordance with the Act. The voting arrangements implemented through the Trust Agreement and the Series A Preferred Stock are designed to give "members" (as defined in Section 3(a)(3)(A) of the Act)¹³ a voice in the management of the Exchange after the Demutualization. These arrangements are necessary for two reasons: (i) Under Delaware law, only stockholders can elect the directors of a Delaware corporation; and (ii) after the Demutualization, Members and Member Organizations that were not Owners at the time of the Demutualization will not be stockholders of the Exchange.

Authorized and Issued Capital Stock

Pursuant to Article FOURTH of the proposed Certificate of Incorporation, after the Merger, the authorized capital stock of the Phlx will consist of:

- 50,500 shares of Class A Common Stock;
- 949,500 shares of Class B Common Stock, par value \$0.01 per share ("Class B Common Stock," and together with the Class A Common Stock, the "common stock"); and
- 100,000 shares of preferred stock, par value \$0.01 per share, one of which will be designated as "Series A Preferred Stock."

Upon consummation of the proposed Demutualization, the only capital stock outstanding will be the 50,500 shares of Class A Common Stock and the single

share of Series A Preferred Stock. The Exchange proposes to authorize more shares of common stock (in the form of the Class B Common Stock) and preferred stock to allow for a more flexible approach to third-party investments and strategic relationships, which the Exchange believes will be critically important to its survival. Article FOURTH of the proposed Certificate of Incorporation will allow the Board of Governors to create and issue in the future additional classes or series of preferred stock without stockholder approval. In a separate undertaking, however, the Exchange has agreed to submit any such creation and issuance of additional classes or series of preferred stock to the Commission pursuant to Section 19(b) of the Act.¹⁴ The issuance and the sale, transfer or other disposition of the Exchange's capital stock will be subject to certain voting and ownership limitations, described below.

Common Stock

Class A Common Stock and Class B Common Stock. Pursuant to Article FOURTH(b)(i) of the proposed Certificate of Incorporation, the Class A Common Stock and the Class B Common Stock will be identical in all respects and will have equal rights and privileges, except for the right to receive the Contingent Dividend (as defined below). Pursuant to Article FOURTH (b)(vi) of the proposed Certificate of Incorporation, each share of Class A Common Stock will automatically convert into one share of Class B Common Stock on the third anniversary of the closing of the Plan of Demutualization (the "Dividend Termination Date").¹⁵ Before the automatic conversion, the proposed Certificate of Incorporation will provide that the Exchange will have to notify the holders of the Class A Common Stock in accordance with certain specific requirements set forth in the Certificate of Incorporation.

Dividends (including the Contingent Dividend). Currently, the existing Certificate of Incorporation provides in Article FOURTH that the Phlx is "not for profit" and "no capital stock shall ever be issued and no dividend shall ever be paid" by the Phlx. After the

¹⁴ 15 U.S.C. 78s(b).

¹⁵ The automatic conversion will be effected as a matter of administrative convenience to consolidate the common stock into a single class after the Contingent Dividend with respect to the Class A Common Stock is no longer potentially payable (*i.e.*, on the Dividend Termination Date). At the time of conversion, because the Contingent Dividend will no longer be potentially payable, the Class A Common Stock and the Class B Common Stock will have identical rights and privileges.

¹³ 15 U.S.C. 78c(a)(3)(A).