



July 16, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File No. SR-NASD-2007-023 – Supplemental Response to Comments

Dear Ms. Morris:

This letter responds to certain comments received by the Securities and Exchange Commission (“SEC,” or “Commission”) regarding the above-referenced filing, a proposed rule change to amend the By-Laws of NASD (“By-Laws,” or “NASD By-Laws”). The proposed rule change would implement governance and related changes to accommodate the planned consolidation of the member firm regulatory operations of NASD and NYSE Regulation, Inc. (“NYSE Regulation”) into NASD, operating under a new name, the Financial Industry Regulatory Authority (“FINRA”). The proposed rule change was published for comment in the Federal Register on March 26, 2007.¹

In separate letters, NASD has already responded to comments on various aspects of the By-Law changes, the By-Law approval process, and FINRA’s arbitration forum.² This letter responds to two issues raised in subsequent comments: (1) allegations that NASD members could have received much more—over eight times as much, according to one commenter—than the \$35,000 they would each receive if the Commission approves the By-Law amendments and the consolidation is eventually completed³; and (2) an assertion that member approval of the

¹ Securities Exchange Act Release No. 55495 (March 20, 2007), 72 FR 14149 (March 26, 2007).

² Letter from Patrice M. Gliniecki, NASD, to Nancy Morris, Commission (May 29, 2007); Letter from Linda D. Fienberg, NASD, to Nancy Morris, Commission (May 29, 2007).

³ *See, e.g.*, Letter from Jonathan W. Cuneo and Richard D. Greenfield to Nancy Morris (June 11, 2007).

proposed By-Laws amendments at a special meeting violated the NASD By-Laws.⁴ As the following discussion makes clear, both of these contentions lack merit.

The \$35,000 Member Payment

NASD is a Delaware nonstock membership corporation exempt from U.S. federal income tax under Section 501(c)(6) of the Internal Revenue Code. Section 501(c)(6) forbids any of NASD's net earnings or revenues from inuring to the benefit of members. Under this provision, NASD would forfeit its tax-exempt status if it paid even \$1 in dividends to its members.⁵

As the letter from William J. Haubert, Esq., of Richards, Layton & Finger, P.A., submitted herewith explains, NASD's certificate of incorporation, which is filed with the Commission, contains a provision very similar to Section 501(c)(6). The certificate specifies that NASD "shall not be conducted for profit" and that "no part of its net revenues or earnings shall inure to the benefit of any individual, subscriber, contributor, or member." Any action that violates Section 501(c)(6) would also violate this provision. Under Delaware law, a corporation cannot engage in any action that would violate its certificate. Therefore, NASD could not structure the proposed transaction, including the member payments, in a way that would violate Section 501(c)(6).

The proposed \$35,000 member payments do not violate Section 501(c)(6) or NASD's certificate of incorporation, however, because they do not represent a dividend or comparable distribution of NASD's assets or "Members' Equity." Rather, as NASD noted in its initial response to comments, the proposed member payments are based on (and limited by) expected future incremental cash flows that would result from the regulatory consolidation. The assertions of some commenters that the proposed \$35,000 payments are not so limited, and that NASD can and should distribute its "Members' Equity," in larger payments of up to \$300,000 per member, are simply incorrect. The combined effect of the prohibition against inurement to members of a tax-exempt organization (as outlined in the letter from Mario J. Verdolini, Esq., of Davis Polk & Wardwell, submitted herewith) and of the certificate provision (as described in Mr. Haubert's letter) makes such an "equity" distribution impermissible.

Moreover, in structuring the transaction, NASD believed that NASD members—who had borne financial burdens associated with duplicative regulation for decades—should benefit from

⁴ See, e.g., Comments of Jack D. Jester (June 4, 2007).

⁵ See 26 U.S.C. § 501(c)(6) (requirement that "no part" of an exempt entity's net earnings inure to any private shareholder or individual); I.R.S. Gen. Couns. Mem. 39862 (Nov. 22, 1991) ("There is no de minimis exception to the inurement prohibition."); see also *Spokane Motorcycle Club v. United States*, 222 F. Supp. 151, 153-54 (E.D. Wash. 1963) (refreshments provided at no cost to club members invalidated tax exemption).

the future efficiencies that would be created by the proposed regulatory consolidation. But, as noted above, any direct payment unrelated to those efficiencies would be inconsistent with NASD's tax-exempt status. As NASD explained in the proxy statement, NASD was not willing to take any action that could "seriously jeopardize" that status. Accordingly, obtaining a private letter ruling from the Internal Revenue Service ("IRS") approving the proposed regulatory consolidation as consistent with NASD's tax exemption was a precondition to closing.⁶

As Mr. Verdolini's letter explains, NASD's request for a private letter ruling raised a number of difficult doctrinal issues. After considering these issues, public IRS guidance, the terms of the initial agreement between NASD and NYSE Group, Inc., and the importance of preserving NASD's tax-exempt status, NASD concluded that \$35,000 was the maximum member payment that the IRS could be expected, with a sufficient degree of confidence, to approve within the timeframe contemplated for the transaction. NASD reached this conclusion, and decided to request the IRS's approval of the regulatory consolidation including a \$35,000 payment, through the exercise of business judgment by its disinterested Board of Governors. A majority of the Board is drawn from outside the securities industry; no Board member had any material conflict in connection with the proposed regulatory consolidation; and no member was dominated by anyone else with such a conflict. And the Board members fully informed themselves concerning the economics of the transaction (in particular the projected cost savings), the practical need for IRS approval, and the likelihood of obtaining that approval before determining that \$35,000 was the maximum sum for which NASD could seek and expect to obtain approval from the IRS. The Board's decision was taken in good faith and in full compliance with the Board members' fiduciary duties, and the resulting business judgment is entitled to deference.

Pursuant to that business judgment, NASD requested a private letter ruling from the IRS approving the proposed regulatory consolidation, including a one-time payment in that amount based on expected future incremental cash flows, examined in conjunction with other costs attributable to the transaction (including future dues rebates to be considered annually by the NASD Board over the following five years). It was on this basis that the IRS agreed to issue such a ruling.

Therefore, the proxy materials accurately state that member payments in excess of \$35,000 would not be possible because such a payment, without the IRS's approval, could "seriously jeopardize" NASD's tax-exempt status. Commenters' assertions to the contrary ignore the limitations imposed by NASD's tax-exempt status and the necessity of obtaining prompt IRS approval of the proposed payment.

⁶ As stated in the proposed rule change, NASD received a favorable ruling by the IRS that the transaction will not affect the tax-exempt status of NASD or NASD Regulation, Inc. Also, as stated in the proposed rule change, on March 7, 2007, NASD and NYSE Group, Inc. filed notification reports with the Department of Justice and the Federal Trade Commission under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. The waiting period for such filing expired on April 6, 2007.

The By-Law Approval Procedure

As already explained in NASD's submission dated May 29, 2007, the proposed amendments to the By-Laws were approved at a special meeting of NASD members, held pursuant to Article XXI of the By-Laws. One commenter has submitted a supplemental letter insisting that NASD members' residual power to amend the By-Laws (subject to the Commission's review), and to do so at a special meeting, is limited by another provision of the By-Laws, Article XVI. Accordingly, this commenter insists, NASD is not permitted to give its members any more than 30 days to consider and vote on a proposed By-Law amendment.

As NASD has already explained, that reading of the By-Laws is incorrect. Mr. Haubert's letter explains the relevant principles of corporate law that empower NASD members to take action on By-Law amendments at a special meeting. Reading the NASD By-Laws in harmony with each other, and with these principles of corporate law, makes clear that NASD acted entirely properly by permitting its members more than 30 days to consider and vote on these proposed By-Law amendments at the special meeting.

Other Issues

In response to comments raised by SEC staff, NASD is advising the Commission that the Charter of FINRA's Nominating Committee provides that at least 20% of the Nominating Committee will be composed of Industry Governors who are associated with members of FINRA. In addition, FINRA will continue extensive member involvement in the administration of its affairs through representation on various subject matter committees, disciplinary hearing panels and the National Adjudicatory Council. Such member participation includes, depending on the particular Committee or group, having input on FINRA's rulemaking process and involvement in the disciplinary process.

The SEC staff also has inquired as to the status of FINRA's adoption of a single, consolidated rulebook applicable to all of its members. NASD expects that FINRA would submit to the Commission within one year of the date of closing of the transaction proposed rule changes that would constitute a significant portion of the consolidated rulebook, with the remaining sections being submitted to the Commission within two years of the closing date.

NASD believes that the foregoing fully responds to the issues raised by the supplemental comments on the proposed rule change. If you have any questions, please call me at (202) 728-8285.

Very truly yours,



T. Grant Callery