nasd 2007023

May 4, 2007

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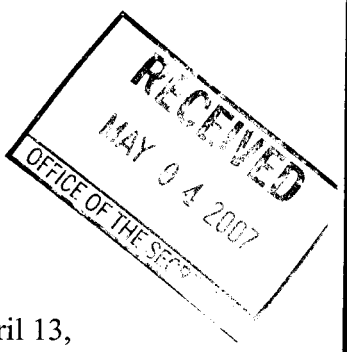

Dear Securities and Exchange Commission Members:

We represent Benchmark Financial Services, Inc. ("Benchmark"). On April 13, 2007, Benchmark submitted a letter comment to the Commission regarding the proposed consolidation of the regulatory arms of the NASD and NYSE. That letter is attached hereto as Attachment "A."

Since sending that letter, there have been additional developments in litigation relating to the consolidation (*Standard Investment Chartered, Inc. v. National Association of Securities Dealers, Inc., et al.*) pending in the United States District Court for the Southern District of New York before the Hon. Shirley Wohl Kram. The principal development is Judge Kram's decision yesterday to dismiss the Amended Complaint on the ground that Plaintiff had not exhausted its remedies before the Commission. Her opinion is attached as Attachment "B."

We have been retained by Benchmark and, together with Standard Investment Chartered, Inc. ("Standard") hereby amend Benchmark's letter comment of April 13, 2007, to add Standard as an additional objector and to bring the following pertinent information to the Commission's attention before any decision is made with respect to the proposed rulemaking. We make this submission without prejudice to our clients' position that the issues in Standard's Amended Complaint (attached hereto as Attachment "C") should be adjudicated by a court of competent jurisdiction, since they ultimately ought to be considered under applicable state law.

We call the Commission's attention to the following statement at page 19 of Judge Kram's opinion:

> The Court is incredulous that the SEC would endorse proposed SRO rule changes that [as alleged in the Amended Complaint] were approved by the membership pursuant to a 'proxy statement that could not possibly pass [muster] under the nation's securities laws and the disclosure requirements of the SEC's own rules (see, e.g., § 14(a) of the Securities Exchange Act of 1934 and Rule 14(a)-9 promulgated thereunder by the SEC and applicable Supreme Court precedent).' (Am. Compl. ¶)

In that regard, Counsel would direct the Commission's attention to highly relevant documents that bear upon Judge Kram's statement and the decision faced by this Commission. Some of these documents were attached to Plaintiff's consolidated opposition to Defendants' motions to dismiss in the above-referenced litigation, but cannot be disclosed because they were filed under seal. *See* Exhibits 7-10 to Plaintiff's Opposition. Attached hereto as Attachment "D" the Commission will find a redacted version of this opposition. We urge the Commission to request from the NASD and NYSE a copy of the unredacted version of this opposition so that it can review them. These documents are by no means exhaustive of the relevant documents produced in the litigation. There are other documents produced in discovery that are highly relevant to the decision being considered by the Commission. Indeed, the Commission should request all the relatively few documents produced in the litigation.

Respectfully Submitted,

Jonathan W. Cuneo, Esq

Richard D. Greenfield, Esq.

cc: Mr. Lynn Sarko, Counsel for Benchmark Financial Services, Inc.

ATTACHMENT "A"

Edward A. H. Siedle, Esq.
President
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Chairman Christopher Cox
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549

April 13, 2007

Dear Commissioner Cox,

I am writing to voice my displeasure regarding the NASD By-Law changes now pending before the SEC. I am the owner of Benchmark Financial Services, Inc., a NASD member firm, as well as a former attorney with the Division of Investment Management of the Securities and Exchange Commission. I am a nationally recognized expert in securities and investment management matters. I appreciate the opportunity to share my perspective and comments.

Respectfully, I consider these By-Law changes a significant injustice to all NASD members, but particularly smaller member firms. The By-Law changes seeking approval before the SEC, unnecessarily and unjustifiably limit the power of voting members (particularly small firms such as mine), they ratify an underpayment to members, and they are the product of a tainted and deceitful proxy statement and voting process.

In my view, the NASD Board and its friends at the NYSE have pulled the proverbial wool over the eyes of the NASD membership, particularly those firms which are not also members of NYSE. There is no rational connection between the traditional long-standing NASD "one firm, one vote" policy and the consolidation of regulatory rules and procedures. It seems that the NASD Board has used this regulatory consolidation – which I do not dispute has some merit – as a means of consolidating its power and, in turn, limiting the power of an institution that has wholly democratic origins.

The essential nature of the regulatory consolidation and the hoped-for operational and supervisory efficiencies, the rationale put forward by the transaction's proponents, must be set forth to the Commission's satisfaction as they are properly within its area of concern and responsibility. In my reading of NASD's submission to the Commission, the justification for the consolidation is not set forth except in the most general terms. You

must be satisfied ultimately that, as proposed, the consolidation is in the public's and members' best interests from a regulatory point of view.

Outside the Commission's area of concern, however, is the manifest unfairness of the proposed transaction to the NASD members who are not also NYSE members and the manner in which NASD, NYSE and their senior officers have carried out the sham member vote on the consolidation using a deceptive proxy statement, coercive tactics and otherwise making a mockery of the process of voting on the transaction and By-law changes. It is my understanding that these latter issues, together with the economic unfairness of the proposed transaction, are being addressed separately by class action litigation pending in federal court in New York City. I refer to these issues so that you may have a clearer understanding of what NASD and NYSE are attempting to pull off which, if "blessed" in any material way by the Commission, will ultimately be a source of embarrassment to the Commissioners and generate further unnecessary Congressional oversight.

It appears that the NASD and NYSE Boards solicited the consolidation in its present form following comments by Commissioners to the effect that having a single broker-dealer regulatory body would be a sensible alternative to the two SROs that presently function. While the approximately 5,000 NASD members have over $1.5 billion in "Members' Equity" as the term is used in NASD's financial statements, the per firm payout is only $35,000. The NASD Board threatens, without any qualification or explanation, that the NASD will lose its tax-exempt status if the payment exceeds $35,000. The $35,000 payment is supposed to represent the cost savings that will be realized by the consolidated SRO over a period of five years. How does the NASD know how much they will save over five years? How did they determine that they could pay five years of savings? Why not four? Six? I have never been pointed to an IRS code section that mandates their seemingly arbitrary limit or provided with an opinion of tax counsel on the matter. I feel entitled as a member to an explanation, to alternatives. The bald assertion that "a larger payment is not possible" made by NASD in its proxy statement is manifestly insufficient. Indeed, the entire proxy statement, which is an almost laughable disclosure document, I believe, as a former SEC attorney, would generate enforcement action by the Commission if it had been generated by a registered company.

The proxy statement does not address the concerns voiced herein. The proxy statement does not help me understand why I need to lose my vote, so that the NYSE and NASD can streamline their regulatory affairs; one has nothing to do with the other. The proxy statement does not explain why $35,000 is the limit of the payment to NASD members; as I read the 2005 Annual Report the "Members' Equity" exceeds $1.5 billion, meaning each member has equity of almost ten times as much as this payment. I suppose I was under the mistaken impression that "Member's Equity" meant that the *equity* belonged to us – the NASD *members*.

I read with great interest that the lawsuit referred to above that is pending against the NASD and the NYSE challenging the proxy solicitation and the proposal's economic

terms. Presumably, all Commissioners have read the operative Complaint in that case. I say kudos to the plaintiff and attorneys in that case for standing up for those whose voice is being silenced. While the SEC may rightfully be the entity to decide whether the transaction may move forward, as I understand it the courts, are the final arbiters with respect to state law issues of NASD's corporate governance and the economic fairness of the proposed consolidation.

It is my understanding that this litigation is proceeding on an expedited schedule. For that reason, if for no others, I request that the Commission defer any decision as to the proposed consolidation until after the absence of *bona fides* of the senior officers of NYSE and NYSE is exposed and the non-regulatory aspects of the consolidation resolved by the Court and/or negotiation by the parties. Once these non-regulatory issues are resolved, one way or another, it would then be appropriate for the Commission to address the remaining issues; i.e. those within its regulatory/supervisory area of responsibility.

Thank you for you attention to this matter. Please call me at (561) 202-0919 if you have any questions or comments.

Very Truly Yours,

Edward A. H. Siedle, Esq.

ATTACHMENT "B"

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

STANDARD INVESTMENT CHARTERED, INC.,	x	
Plaintiff,	x	07 Civ. 2014 (SWK)
-against-	x	
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., et al.,	x	**OPINION AND ORDER**
Defendants.	x	

SHIRLEY WOHL KRAM, U.S.D.J.

On March 8, 2007, plaintiff Standard Investment Chartered, Inc. ("Standard") filed a class action complaint challenging the pending regulatory consolidation of the National Association of Securities Dealers, Inc. ("NASD") and the NYSE Group, Inc. ("NYSE") (the "Consolidation"). On March 26, 2007, the Securities and Exchange Commission ("SEC" or "Commission") published notice of proposed rule changes attendant to the Consolidation, and invited comment thereon. Shortly thereafter, Standard filed an amended complaint, asserting several additional claims against the NASD, three NASD officers (together, the "NASD Defendants"), and the NYSE. Now before the Court are motions to dismiss filed by the NASD Defendants and the NYSE on grounds of failure to exhaust administrative remedies, ripeness, immunity, and failure to state a claim upon which relief may be granted. For the reasons that follow, the

Court finds that Standard has failed to exhaust its administrative remedies, and grants the defendants' motion to dismiss under Federal Rule of Civil Procedure 12(b)(1).

I. BACKGROUND

The NYSE, through its subsidiary, New York Stock Exchange LLC, and the NASD are both self-regulatory organizations ("SROs") registered with the SEC pursuant to the Securities Exchange Act of 1934 (the "Exchange Act"). "As an SRO, the NASD is, like other SROs such as [the NYSE], authorized by Congress to 'promulgate and enforce rules governing the conduct of its members,'" and is subject to oversight by the SEC. DL Capital Group, LLC v. NASDAQ Stock Mkt., Inc., 409 F.3d 93, 95 (2d Cir. 2005) (citing Barbara v. New York Stock Exch., Inc., 99 F.3d 49, 51 (2d Cir. 1996)). The individual defendants, Mary L. Schapiro ("Schapiro"), Richard F. Brueckner ("Brueckner"), and Barbara Z. Sweeney ("Sweeney"), hold various positions of authority within the NASD, and all are alleged to have been actively involved in promoting the Consolidation.

On November 28, 2006, the NASD and the NYSE announced "a plan to consolidate their member regulation operations into a combined organization that will be the sole U.S. private-sector provider of member firm regulation for securities firms doing business with the public." (Am. Compl. ¶ 22.) As the consolidation of these entities requires the NASD to amend its

By-Laws, "the defendants solicited votes of NASD members in support of the [Consolidation] pursuant to a proxy statement dated December 14, 2006," and "scheduled a vote [of NASD members] on January 19, 2007" (Compl. ¶ 23), at which time the By-Law amendments were approved by a majority of voting members.

On March 8, 2007, the plaintiff, a member of the NASD, initiated the instant lawsuit as a class action, alleging that the Consolidation will disenfranchise certain NASD members and that the defendants failed to comply with Delaware state law while soliciting support for the Consolidation. The complaint sought an injunction barring the Consolidation and enactment of the proposed By-Law amendments, the issuance of a revised proxy statement, damages, and assorted other relief. On March 19, 2007, the NASD filed with the SEC the proposed By-Law amendments, which the SEC then published on March 26, 2007, in order to solicit comments from interested persons.

On April 10, 2007, the plaintiff filed an amended complaint. In addition to the three claims alleged in its initial complaint--(I) that Schapiro, Brueckner, and Sweeney breached fiduciary duties to the proposed class in negotiating the Consolidation and failing to disclose all material facts in the proxy statement; (II) that all defendants engaged in negligent misrepresentation with respect to the proxy statement; and (III) that the NYSE and the individual defendants will be

unjustly enriched by the Consolidation--Standard now alleges (IV) that NASD members have been denied their right to elect Governors of the NASD in violation of section 211 of the Delaware General Corporation Law; (V) that all defendants have improperly converted or, if the Consolidation is effected, will have taken the prospective class members' assets and/or "Member's Equity" (Am. Compl. ¶¶ 87-90); (VI) that all defendants have caused a substantial diminution in the value of NASD membership, with imminent completion of such diminution; and (VII) that all defendants have deprived the prospective class members of their voting membership. In Standard's words, the gravamen of the amended complaint "is that the terms of the consolidation represent a massive disenfranchisement of plaintiff and the members of the Class . . . and that their consent thereto was obtained only through a 'bum's rush' campaign" by the defendants. (Am. Compl. ¶ 2.)

II. DISCUSSION

The defendants move to dismiss the amended complaint under Federal Rule of Civil Procedure 12(b)(1) and (6). With respect to Rule 12(b)(1), the defendants argue that the Court lacks jurisdiction to consider the claims in the amended complaint because Standard has failed to exhaust its administrative remedies. See Hayden v. New York Stock Exch., Inc., 4 F. Supp. 2d 335, 338 (S.D.N.Y. 1998). As the following discussion

explains, challenges to NASD rulemaking, and the procedures incident to that rulemaking, are subject to the exhaustion doctrine. Because Standard has not exhausted its administrative remedies, the Court dismisses the amended complaint under Rule 12(b)(1). In light of this holding, the Court finds no occasion to reach the defendants' alternative grounds for dismissal under Rule 12(b)(6).

It is settled law that plaintiffs "must exhaust their administrative remedies before the SEC prior to attempting to obtain judicial review" of certain claims against that agency. Touche Ross & Co. v. Sec. & Exch. Comm'n, 609 F.2d 570, 582 (2d Cir. 1979). SROs, such as the NASD and the NYSE, are defined and limned by the Exchange Act, and are granted certain regulatory authority thereunder that would otherwise be exercised by the SEC. Therefore, courts have widely held "that the doctrine of exhaustion of administrative remedies, in appropriate circumstances, appl[ies] to challenges to disciplinary proceedings of" SROs. Barbara, 99 F.3d at 57; accord Swirsky v. Nat'l Ass'n of Sec. Dealers, 124 F.3d 59, 62 (1st Cir. 1997) (invoking exhaustion doctrine in context of a challenge to NASD disciplinary proceedings); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Nat'l Ass'n of Sec. Dealers, Inc., 616 F.2d 1363, 1370 (5th Cir. 1980) (same); First Jersey Sec., Inc. v. Bergen, 605 F.2d 690, 696 (3d Cir. 1979) (same); Datek Sec. Corp. v.

Nat'l Ass'n of Sec. Dealers, Inc., 875 F. Supp. 230, 233 (S.D.N.Y. 1995) (same). Although less common, courts in this District have also concluded that the exhaustion doctrine equally applies to both delisting disputes, see Belfort v. Nat'l Ass'n of Sec. Dealers, Inc., No. 93 Civ. 7159 (JSM), 1994 WL 97021, at *1 (S.D.N.Y. Mar. 24, 1994), and challenges to SRO rule changes. See, Am. Benefits Group v. Nat'l Ass'n of Sec. Dealers, No. 99 Civ. 4733 (JGK), 1999 WL 605246, at *8 (S.D.N.Y. Aug. 10, 1999).

Relying on these precedents, the defendants contend that the proposed By-Law amendments necessary for the Consolidation's consummation are an exercise of the NASD's rulemaking authority, and thus Standard must exhaust its administrative remedies under the Exchange Act before seeking judicial review. In essence, the defendants argue that the exercise of rulemaking authority here falls within the "complex self-regulatory scheme" enforced by the SEC, Merrill Lynch, 616 F.2d at 1368 (5th Cir. 1980), and thus all of the plaintiff's arguments--regarding substantive unfairness resulting from the By-Law amendments, the process by which the amendments were approved, and the alleged unjust enrichment arising therefrom--must be resolved by the SEC in its currently pending review.

Standard counters that it is not challenging the substance of the proposed By-Law amendments or the Consolidation per se;[1] rather, it is challenging the "defendants' failure to comply with Delaware state law in soliciting support among NASD members for the proposed NASD-NYSE regulatory consolidation . . . ." (Am. Compl. ¶ 1.) Fundamentally, Standard argues that the defendants' solicitation of support for the Consolidation, most obviously embodied in the proxy statement, and the underlying regulatory consolidation of the two organizations are governed by state corporate law, and thus the exhaustion doctrine is inapplicable.

Therefore, the principal questions before the Court are (1) whether challenges to NASD rulemaking are subject to the exhaustion doctrine; and, if so, (2) whether the procedures incident to the rulemaking at issue here are properly considered a part of the NASD's rulemaking authority, such that challenges to those procedures are subject to the exhaustion doctrine.

The NASD was incorporated on September 3, 1936, as a nonstock corporation in the State of Delaware. See Restated Certificate of Incorporation of Nat'l Ass'n of Sec. Dealers,

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[1] Standard's position on this point has evolved over the course of this litigation. Compare Compl. ¶ 1 ("This is a Class Action brought against the defendants that challenges the fairness to NASD members of the NASD-NYSE regulatory consolidation . . . ."), with Am. Compl. ¶ 1 ("This Complaint does *not* challenge the wisdom of a consolidation of these two [SROs] . . . .") (emphasis in original).

Inc. Shortly thereafter, on August 7, 1939, the SEC granted the organization's application to become a national securities association pursuant to the Exchange Act. In re Application by Nat'l Ass'n of Sec. Dealers, Inc., 5 S.E.C. 627 (1939). The NASD's certificate of incorporation indicates, inter alia, that it is intended "to provide a medium for effectuating the purposes of [Section 15A of the Exchange Act]," and that "the members shall be entitled to vote . . . on any amendment to the By-Laws of NASD . . . ." See Restated Certificate of Incorporation of Nat'l Ass'n of Sec. Dealers, Inc. In addition, Article XVI of the NASD's By-Laws states that the NASD Board of Governors, following Board approval of a proposed By-Law amendment, "shall forthwith cause a copy to be sent to and voted upon by each member of the NASD." NASD By-Laws, art. XVI. Before taking effect, amendments must be approved first by a majority of voting members and then by the SEC under the relevant provisions of the Exchange Act. Id.

Congress has broadly defined an SRO's rules as including the organization's "constitution, articles of incorporation, [and] bylaws." 15 U.S.C. § 78c(a)(27). The Exchange Act "authorizes the SEC to exercise a significant oversight function over the rules and activities of the registered associations," United States v. Nat'l Ass'n of Sec. Dealers, Inc., 422 U.S. 694, 700-01 n.6 (1975) (citation omitted), "including the

responsibility to approve or reject any rule, practice, policy, or interpretation proposed by an SRO." DL Capital Group, 409 F.3d at 95 (citing 15 U.S.C. § 78s). This oversight is achieved through a tiered review process.

With limited exceptions not relevant here, all proposed SRO rule changes must be filed with the SEC before taking effect. See 15 U.S.C. § 78s(b)(1). The SEC must then publish notice of the proposed rule change and provide an opportunity for interested persons to comment thereon. Id. The Commission may not approve a proposed rule change absent a finding "that such proposed rule change is consistent with the requirements of [the Exchange Act] and the rules and regulations thereunder applicable to such organization." Id. § 78s(b)(2). For instance, when considering an organization's application for registration as an SRO, the SEC is charged with evaluating whether the rules of the organization "assure a fair representation of [the organization's] members in the selection of its directors and administration of its affairs;" "provide for the equitable allocation of reasonable dues, fees, and other charges among" the organization's members and other relevant parties; and "are not designed to permit unfair discrimination between . . . brokers[] or dealers." 15 U.S.C. § 78o-3(b)(4),(5) & (6). Thus, when reviewing a proposed rule change such as the proposed By-Law amendments here, the SEC is necessarily charged with

ensuring that the proposed rule change does not betray the baseline Exchange Act requirements on which SRO registration is conditioned. Furthermore, following a final SEC order approving a proposed rule change, the Exchange Act provides for review by the United States Court of Appeals. 15 U.S.C. § 78y(a).

Judge Koeltl relied on this comprehensive system of review in his dismissal of a lawsuit seeking to prevent the implementation of rules that had been approved by both the NASD and the SEC. See Am. Benefits Group, 1999 WL 605246, at *5-*8. Even though pre-approval review was no longer an option in that case, as it is here, Judge Koeltl observed that the plaintiff "had the opportunity to challenge [the rules] for sixty days after the Commission's approval of the NASD's proposed amendments . . . by petitioning the SEC and by filing a petition for review in the appropriate court of appeals." Id. at *5. By failing to challenge the rules in the appropriate forum, the plaintiff "denied the SEC the opportunity to address [the plaintiff's] concerns." Id. The Court agrees with Judge Koeltl that the exhaustion doctrine is properly applied to NASD rulemaking, including the amendment of its By-Laws. The scope of activities properly considered a valid part of NASD rulemaking, however, requires further examination.

As the exhaustion doctrine has been most fully developed in the context of SRO disciplinary proceedings, that context

provides guidance in determining the scope of activities that are properly considered part of the NASD rulemaking process for purposes of applying the exhaustion doctrine. In the disciplinary context, it is not uncommon for plaintiffs to attempt to avoid application of the exhaustion doctrine by alleging that an SRO violated state law not only with respect to the result of a disciplinary proceeding but also with regards to actions taken before, and in conjunction with, a proceeding. See, e.g., Swirsky, 124 F.3d at 61 n.1 (alleging tortious interference with contract and advantageous relations, fraud, defamation, and other state law violations pursuant to the settlement of an administrative proceeding); First Jersey, 605 F.2d at 693 (alleging interference with contractual and business relations prior to the initiation of a disciplinary hearing); Bruan, Gordon & Co. v. Hellmers, 502 F. Supp. 897, 900, 904 (S.D.N.Y. 1980) (alleging that conspiracy, tortious interference, and fraud pervaded an investigative audit and communications preceding a disciplinary proceeding). Such attempts to avoid exhaustion are invariably unsuccessful.

Bruan, Gordon is particularly instructive. In that case, the plaintiff, an NASD member, alleged that the NASD violated various state laws when it "carried out a 'dragnet' audit of plaintiff's books and records." Id. at 904. The Court noted that the plaintiff did not "contend that the NASD lack[ed] authority

to conduct such an audit," but "only complained of the manner in which the audit was conducted." Id. at 906. As such, "[t]he disciplinary proceeding provide[d] an obvious administrative forum for plaintiff to press its contention that the audit was improperly conducted." Id. The plaintiff also claimed that the unavailability of adequate administrative remedies obviated the need for direct complaint to the SEC, but Judge Motley concluded that this was itself evidence of a failure to exhaust remedies because "[t]he way to demonstrate that a remedy is inadequate is to exhaust it or point to prior demonstrated inadequacies." Id. at 908.

As is the case with challenges to procedures incident to SRO disciplinary actions, plaintiffs may not circumvent the exhaustion doctrine by framing their grievances as a challenge to the procedures incident to SRO rulemaking. In fact, despite the different context of Bruan, Gordon, the details of that case are strikingly analogous to the current litigation, right down to the charged rhetoric of the respective complaints. Just as the plaintiff in Bruan, Gordon contested the "dragnet" manner in which an authorized audit was conducted, and not the authority to conduct that audit in the first place, Standard does not, and cannot, challenge the NASD's authority to issue a proxy statement seeking membership approval of the proposed By-Law amendments; rather, it complains of the manner in which the

proxy solicitation was conducted, "through a 'bum's rush' campaign by all defendants . . . so as to create an apparent stampede in favor of the Transaction." (Am. Compl. ¶ 2.) Nor does Standard describe any attempt to bring its concerns regarding the allegedly "one-sided, deceptive and conclusory proxy statement" (Am. Compl. ¶ 2) to the attention of the NASD or the SEC, despite the existence of an ongoing SEC review of the proposed By-Law amendments that were adopted pursuant to that proxy statement. Cf. Bruan, Gordon, 502 F. Supp. at 906 (remarking that if the plaintiff alleges that a procedure "was conducted in a biased fashion, then plaintiff must demonstrate that bias by initially pressing its complaint before the NASD").

In fact, Standard has eschewed even greater opportunities for administrative review than did the plaintiff in Bruan, Gordon. Id. at 908 (noting that "Plaintiff could have complained directly to the SEC," that the "SEC has statutory authority to bring an injunctive action . . . against any SRO" pursuant to section 21(d) of the Exchange Act, and that the "SEC may also commence its own administrative proceedings against an SRO" pursuant to section 19(h) of the Exchange Act). As the SEC is currently considering the proposed rule change adopted pursuant to the contested proxy solicitation, and has requested comment on that proposed change, the plaintiff has had, and arguably still has, the opportunity to challenge the rulemaking before

the SEC in the first instance, not to mention on review. See Am. Benefits Group, 1999 WL 605246, at *5. Under these circumstances, the Court sees no appreciable difference between requiring plaintiffs to exhaust administrative remedies before challenging procedures used as part of an SRO's disciplinary proceedings, and insisting upon exhaustion when plaintiffs challenge procedures employed as part of an SRO's rulemaking authority. This follows from the proposition that the SEC has power to oversee the procedures incident to rulemaking, which is comparable, if not equal, to its power to review the procedures incident to an SRO's disciplinary proceedings. Therefore, Standard's claims challenging the proxy solicitation incident to the proposed By-Law amendments must be dismissed in favor of the current SEC review proceeding.

This conclusion is reinforced by the considerable scope of the SEC's control over SRO rulemaking. Textually, that control far exceeds the mere ability to review proposed rule changes. Section 19(c) of the Exchange Act provides the SEC with the power to sua sponte amend the rules of an SRO "as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization, conform its rules to requirements of [the Exchange Act] and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of the purposes of [the Exchange Act]." 15 U.S.C. §

78s(c). Thus, because the rules of an SRO include its bylaws and articles of incorporation, the SEC theoretically has the authority under section 19(c) to sua sponte impose the By-Law amendments at issue here without a vote of the NASD membership, or under section 19(b) to disapprove a proposed By-Law amendment that was unanimously approved by the NASD membership. By registering as an SRO, an organization and its members necessarily forfeit certain powers held prior to the organization's registration.

The pervasive references to the Exchange Act throughout the NASD's governing documents, see supra, underscore this proposition. NASD regulatory actions are largely bound by the overarching purposes of the Exchange Act. Thus, the rules of an SRO are not solely within the control of its members, but must be informed by, and are subject to, the Exchange Act's essential mandate that SROs protect investors and the public interest. See 15 U.S.C. § 78o-3(a). In this sense, the SEC's considerable control over all aspects of SRO rulemaking is a fundamental part of the Exchange Act and its comprehensive scheme regulating the securities markets and the actors, such as brokers and dealers, which facilitate those markets. Thus, plaintiffs must initially challenge SRO rulemaking in front of the agency that administers the Exchange Act and in accordance with that agency's administrative scheme.

The exhaustion doctrine is especially appropriate here, where all of the remedies sought by Standard are either provided by the Exchange Act's administrative scheme or are plainly improper. Standard seeks primarily declaratory and injunctive relief with respect to the dissemination of the proxy statement and the consummation of the Consolidation. This type of relief is commonly requested in lawsuits attempting to avoid the exhaustion doctrine, and such claims are commonly dismissed nonetheless. See, e.g., Touche Ross, 609 F.2d at 573-74 (dismissing claim seeking declaratory and injunctive relief for failure to exhaust administrative remedies); Hayden, 4 F. Supp. 2d at 336, 340 (same). The Exchange Act grants the SEC numerous powers to seek an injunction, censure, and limit an SRO's activities, and to remove an officer or director of an SRO from office if "if he or she is found to have violated the rules or abused his or her position." Swirsky, 124 F.3d at 62 (citing 15 U.S.C. §§ 78u(d), 78s(h)(1), and 78s(g)(2)). These provisions are directly responsive to nearly all of Standard's prayer for relief.

In addition, Standard demands an accounting of its "Members' Equity." (Am. Compl. 27.) Yet the NASD's articles of incorporation clearly state that the "NASD is not organized and shall not be conducted for profit, and no part of its net revenues or earnings shall inure to the benefit of any

individual, subscriber, contributor, or member." Restated Certificate of Incorporation of Nat'l Ass'n of Sec. Dealers, Inc. Standard has not provided any support for the proposition that it is entitled to NASD assets or an accounting thereof. Furthermore, the Exchange Act provides the SEC with the power to review "dues, fees, and other charges among members," 15 U.S.C. § 78o-3(b)(5); thus, to the extent that Standard questions the allocation of any "cash payments and dues credits" pertinent to the Consolidation (Am. Compl. ¶ 2), the SEC is well-positioned to address such concerns and has the tools at its disposal to do so.

As for Standard's request for damages, those claims are based entirely on a future contingency--the Consolidation's consummation. Therefore, although the Second Circuit has indicated that damages claims should generally not be dismissed on exhaustion grounds, that presumption carries less force where the plaintiff does not seek "compensation for past harms," but merely includes a speculative claim for future damages in the event a companion request for injunctive relief is denied. Barbara, 99 F.3d at 57 (citing Plano v. Baker, 504 F.2d 595, 599 (2d Cir. 1974) ("[A] boilerplate claim for damages will not automatically render the administrative remedy inadequate.")). Because Standard is also challenging the very condition that would cause its speculative "monetary" damages, and that

challenge is itself subject to exhaustion, allowing Standard's monetary claims to proceed on their own would unduly circumvent the purpose of the exhaustion doctrine.

In requiring Standard to exhaust its administrative remedies, the Court also takes note of the SEC's considerable experience with the substance of the claims alleged here. The SEC is charged with reviewing whether an SRO "assures a fair representation of its members in the selection of its directors and administration of its affairs." See 15 U.S.C. § 78o-3(b)(4). It follows that the agency is required to ensure not only that the proposed By-Law amendments meet the goal of fair representation, but that the procedure by which the By-Law amendments were adopted also fulfills this goal. Although the SEC is not generally charged with reviewing the communications of nonstock corporations, those nonstock corporations that register to become SROs place themselves within the ambit of the SEC's authority to the extent described by Congress in the Exchange Act. This includes the oversight, and even the forfeiture, of their rulemaking authority as related to the purposes of the Exchange Act. 15 U.S.C. § 78s(b) & (c).

It is hard not to appreciate the irony inherent in the contention that the SEC is an unsuitable forum in which to consider whether the NASD as a corporation is "speak[ing] the truth when talking to its" members, Sec. & Exch. Comm'n v. Nat'l

Sec., Inc., 393 U.S. 453, 463 (1969), given that the SEC is fundamentally engaged in regulating the verity of almost identical communications made by issuers to their stockholders. The Court is incredulous that the SEC would endorse proposed SRO rule changes that were approved by the membership pursuant to a "proxy statement that could not possibly pass [muster] under the nation's securities laws and the disclosure requirements of the SEC's own rules (see, e.g., § 14(a) of the Securities Exchange Act of 1934 and Rule 14a-9 promulgated thereunder by the SEC and applicable Supreme Court precedent)." (Am. Compl. ¶ 4.) Furthermore, SEC approval of the proposed By-Law Amendments is always subject to review by the United States Court of Appeals. 15 U.S.C. § 78y(a).

Ultimately, the consolidation of the regulatory operations of two organizations currently regulating brokers and dealers is within the SEC's expertise. The apportionment of voting rights held by brokers and dealers within their organization is also expressly subject to SEC oversight pursuant to the Exchange Act. Furthermore, the SEC has relevant expertise regulating corporate disclosures in the context of the securities markets. Thus, substantively, as well as procedurally, the SEC is well-suited to consider the allegations of the amended complaint.

Standard does not challenge the policy behind applying the exhaustion doctrine to the SRO rulemaking process generally, nor

does it provide any relevant precedents in which a similar exhaustion defense was considered and rejected. Rather, Standard argues that state law is not supplanted by federal securities law and that state corporate law plays an important role in the governance of SROs, as demonstrated most recently in cases involving the NYSE and the Philadelphia Stock Exchange ("PHLX"). Nonetheless, the arguments and authority provided by Standard do not compel a result different from the one reached here.

In the first place, this Opinion does not consider whether Delaware state law is supplanted by the Exchange Act. Holding that Standard is required to exhaust its administrative remedies here preempts state law no more or less than does the application of the exhaustion doctrine to claims alleging violations of state law in the context of SRO disciplinary proceedings. See, e.g., Swirsky, 124 F.3d at 61 n.1, 62 (dismissing tortious interference, fraud, defamation, and other state law violations for failure to exhaust administrative remedies); Bruan, 502 F. Supp. at 900, 904, 906 (dismissing conspiracy, fraud, and tortious interference claims for failure to exhaust administrative remedies). By its very nature the exhaustion doctrine deprives a party of the right to file suit prior to exhausting its claims before the appropriate

administrative body; Standard's citation to preemption cases is therefore inapposite.[2]

With respect to the role of state corporate law in the governance of SROs, none of Standard's authorities address the issue of exhaustion, nor do they involve an SRO's exercise of its rulemaking authority. For instance, New York v. Grasso, 350 F. Supp. 2d 498 (S.D.N.Y. 2004), presented the question of whether an action alleging that the NYSE violated a New York State law by paying an executive unreasonable compensation was properly removed to federal court. Id. at 499-500. Judge Lynch remanded the case, concluding that federal jurisdiction was not appropriate "where a state agency seeks to enforce state laws relating to the compensation of officers or employees of a self-regulating organization." Id. at 507. Not only was there no consideration of exhaustion in Grasso, but the SRO action at issue in that case was wholly unrelated to the regulatory powers granted by the Exchange Act and overseen by the SEC. The proposition that a federal court does not have jurisdiction over

[2] Furthermore, Standard's only authority on preemption related to the regulation of the securities industry was decided prior to the Securities Act Amendments of 1975, which "drastically shifted the balance of rulemaking power in favor of Commission oversight." Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119, 1129 (9th Cir. 2005). In fact, courts have more recently concluded that "SRO rules that have been approved by the Commission pursuant to 15 U.S.C. § 78s(b)(2) preempt state law when the two are in conflict, either directly or because the state law stands as an obstacle to the accomplishment of the objectives of Congress." Id. at 1132.

a lawsuit that does not involve any SRO actions subject to SEC oversight fails to persuade the Court that it should take jurisdiction over a rulemaking that is currently being reviewed by the SEC.[3]

Nor does the existence of state court actions related to the demutualization of the NYSE, see In re New York Stock Exch./Archipelago Merger Litig., 824 N.Y.S.2d 764, 2005 WL 4279476, at *2 (N.Y. Sup. Ct. 2005) (discussing a settlement in the context of the NYSE's plan "to convert the NYSE's not-for-profit status into a public, for-profit corporation"), or the PHLX, see Ginsburg v. Philadelphia Stock Exch., Inc., Civ. A. No. 2202-N, at 6 (Del. Ch. Dec. 7, 2006) (Pl.'s Opp. Ex. 6), affect the Court's analysis of the applicability of the exhaustion doctrine in the specific circumstances of this case.

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[3] Securities Exchange Commission v. National Securities, Inc., 393 U.S. 453, 463 (1969), is no more helpful to Standard's position. In that case, the Supreme Court held that a state law regulating the insurance industry did not support McCarran-Ferguson Act preemption of a securities action brought by the SEC in an attempt to "protect security holders from fraudulent misrepresentations," and thus the proceedings could exist contemporaneously. Id. at 463. However, the Court noted: "Different questions would, of course, arise if the Federal Government were attempting to regulate in the sphere reserved primarily to the States by the McCarran-Ferguson Act. But that is not this case." Id. In light of this distinction, the value of National Securities to Standard's argument is questionable. Indeed, not only does this undermine the plaintiff's preemption argument, as the Supreme Court recognized the supremacy of federal law, but the Court also noted the preeminent position of the SEC in protecting corporate constituents from misrepresentations.

The failure of the defendants in those actions to raise an exhaustion argument has no bearing on the legal analysis to be applied to the contentions raised in this litigation, regardless of any passing resemblance the context of those actions may have to the broader context in which the NASD rulemaking here is taking place.

Finally, although Standard does not explicitly argue that its claims fall into any exceptions to the exhaustion doctrine, see, e.g., Am. Benefits Group, 1999 WL 605246, at *7 (citing Guitard v. U.S. Sec'y of the Navy, 967 F.2d 737 (2d Cir. 1992)), the Court, having considered the amended complaint and Standard's submissions, finds that Standard's allegations are insufficient for this case to fall within any of those exceptions.

III. CONCLUSION

For the reasons discussed above, the Court grants the defendants' motions to dismiss the amended complaint under Federal Rule of Civil Procedure 12(b)(1) for failure to exhaust administrative remedies. The Clerk of Court is directed to enter judgment for the defendants dismissing all claims and closing this case.

SO ORDERED.

SHIRLEY WOHL KRAM
UNITED STATES DISTRICT JUDGE

Dated: New York, New York
May 2, 2007

ATTACHMENT "C"

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

STANDARD INVESTMENT CHARTERED, INC. On behalf of itself and all others similarly situated,	
Plaintiff,	**Case No.07-CV-2014 (SWK)**
v.	
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. (a/k/a "NASD"); NYSE GROUP, INC.; MARY L. SCHAPIRO; RICHARD F. BRUECKNER and BARBARA Z. SWEENEY	**CLASS ACTION** **JURY TRIAL DEMANDED**
Defendants.	

AMENDED COMPLAINT

INTRODUCTION

Plaintiff Standard Investment Chartered, Inc. ("Standard" or "Plaintiff"), for its Complaint against defendants National Association of Securities Dealers, Inc. ("NASD"), NYSE Group, Inc. ("NYSE"), Mary L. Schapiro, Richard F. Brueckner and Barbara Z. Sweeney, alleges upon information and belief and upon investigation of counsel as follows:

1. This is a Class Action brought against defendants that challenges chiefly defendants' failure to comply with Delaware state law in soliciting support among NASD members for the proposed NASD-NYSE regulatory consolidation ("the Transaction") described below. This Complaint does not challenge the wisdom of a consolidation of these two self-regulatory organizations ("SROs"), a transaction encouraged by the Securities & Exchange Commission ("SEC"); rather, it challenges the deceptive manner through which the Transaction is being foisted upon those members of NASD that are not also members of NYSE and its

essentially unfair terms and conditions which have harmed and will irreparably harm plaintiff and the members of the Class. Among other things, plaintiff seeks declaratory and injunctive relief to prevent a proposed plan to consolidate NASD and NYSE from becoming effective in the absence of a proxy statement that is fair, balanced, accurate, informative and complete as required by applicable law; to enjoin certain proposed by-law and other governance changes that would occur pursuant to the Transaction in the absence of a legal vote of the membership of NASD; and to recover damages on behalf of plaintiff and the members of the Class defined below.

2. The gravaman of this Complaint is that the terms of the consolidation represent a massive disenfranchisement of plaintiff and the members of the Class – those NASD members that are not also NYSE members – and that their consent thereto was obtained only through a "bum's rush" campaign by all defendants that included, *inter alia*, public relations ballyhoo, a one-sided, deceptive and conclusory proxy statement that failed to explain how critical choices were made by defendants, uniform cash payments and dues credits that appear to be little more than a monetary inducement to small NASD firms to exercise their votes under the "one firm, one vote" so as to create an apparent stampede in favor of the Transaction. In fact, The New York Times has directly asked "Is this a case of vote buying?" ("Let's Vote on Securities Rules. Oh, and Here's $35,000," (NYT 11/29/06)).

3. Other aspects of the Transaction were particularly shabby as well. The proponents provided an abbreviated period of one month for NASD members to vote based upon material facts having been concealed (during the holiday season) and an undocumented threat of federal regulatory intervention unless the Transaction was approved.

4. It is particularly dangerous, disappointing, ironic and disingenuous that those responsible for self-regulating our nation's securities markets would employ such tactics, which include a proxy statement that could not possibly pass master under the nation's securities laws and the disclosure requirements of the SEC's own rules (*see, e.g.* §14(a) of the Securities Exchange Act of 1934 and Rule 14a-9 promulgated thereunder by the SEC and applicable Supreme Court precedent).

5. The defendants also violated Delaware Law in not presenting the NASD-NYSE contract itself (as opposed to merely the proposed changes in the by-laws) to the NASD Membership for a vote. Under applicable Delaware law, the Transaction itself had to be submitted to a membership vote, but this was not done.

6. Apparently to avoid a showdown over the controversial consolidation plan, the NASD has failed to schedule an annual meeting of members for the election of new Governors within the time required by Delaware law.

7. This action is brought on behalf of plaintiff and the Class, consisting of all members of record of NASD (other than those which were also concurrently members of NYSE) at the time of a Special Meeting of NASD Members held on January 19, 2007 ("Special Meeting"), as set forth in detail below.

JURISDICTION AND VENUE

8. This Court has diversity jurisdiction over this action under 28 U.S.C. § 1332(d) because there is diversity of citizenship between at least one Class Member (the plaintiff) and each defendant, and the matter in controversy seeks damages in excess of $5,000,000.

PARTIES

9. Plaintiff Standard is a California corporation with its principal place of business in Tustin, Orange County, California. At the time of the Special Meeting and at all other times relevant, plaintiff was a member of NASD. Plaintiff is not and was not a member of NYSE.

10. Defendant NASD is a not-for-profit corporation organized and existing under the laws of the State of Delaware, with its principal place of business located at 1735 K Street, NW, Washington, D.C. 20006. Its regulatory activities are in part governed and supervised by the SEC. Notwithstanding the role of the SEC with respect to its regulatory activities, the internal and business affairs of NASD are conducted under and pursuant to applicable Delaware law.

11. The regulatory jurisdiction of the SEC is by no means exclusive. Not only is NASD itself and its governance a matter of Delaware state law, but federal governmental agencies (other than the SEC) have been involved in passing upon specified aspects of it and its operation. These include the Antitrust Division of the Department of Justice and/or the Federal Trade Commission with respect to whether, *inter alia*, the Transaction was not in violation of federal antitrust laws and governmental policy and the Internal Revenue Service with respect to whether there were tax implications which would cause intervention.

12. Defendants NYSE and NASD (as well as their officers and governors), like other stock exchanges, are susceptible to suit in United States District Courts as well as state courts.

13. This action is not a derivative one brought on behalf of NASD and/or all of its members. Indeed, it is a direct and representative action brought by plaintiff on behalf of itself and the members of the Class against NASD and the other defendants.

14. NASD is a self-regulatory agency ("SRO") which was established initially to regulate the conduct of brokers and dealers in securities, and to deal with customer disputes.

Ultimately it organized a profit-making marketplace for the trading of securities known as NASDAQ.

15. NASD is also a membership organization. It has approximately 5,100 members, of which only about 200 are also members of NYSE. NASD has traditionally operated in a populist, decentralized and democratic manner. This "way of life" is threatened by the Transaction.

16. NASD has a huge amount of assets. Its 2005 Annual Report reflects "Members' Equity" of $1,611,254,000, most of which is a result of the sale of NASDAQ. According to The Wall Street Journal, NASD received approximately $1.5 billion from the sale of the NASDAQ securities market (WSJ 12/15/05).

17. This huge pool of cash has been used as an asset to offset member fees and issue rebates. ("NASD Investment Fund Swells from Sale of NASDAQ Stock; It will Deploy Cash to Take on the NYSE, Observers Say") (Investment News 6/12/06). It is this cash pool of Members' Equity that is the cash source of the $35,000 payment (NYT 11/27/06).

18. Defendant NYSE is a corporation organized and existing under the laws of the State of Delaware, with its principal place of business located at 11 Wall Street, New York, NY 10005. NYSE, through a subsidiary, NYSE Regulation, Inc., is an SRO which operates to regulate the conduct of its members and to deal with customer disputes. NYSE is the successor in interest to the New York Stock Exchange which, in March, 2006, was merged with Archipelago Holdings, Inc., a profit-making corporation. NYSE is now a publicly traded company, the securities of which trade on the New York Stock Exchange. Acting in concert with the other defendants, NYSE, many of its members and senior officers, solicited members of the NASD to vote in favor of the Transaction described herein. Further, NYSE, acting through

its officers and representatives, participated in the drafting of language which appeared in the NASD Proxy Statement at issue herein. Indeed, information on the Transaction appears on the NYSE website (www.nyse.com/pdfs/TransactionFactSheet.pdf).

19. Defendant Mary L. Schapiro is an individual who is a citizen of the District of Columbia who serves as Chairman and CEO of NASD. Upon consummation of the transaction described below, Ms. Schapiro will become Chief Executive Officer of the combined entity. Ms. Schapiro has been actively involved in lobbying for and urging acceptance of the Transaction. By reason of their positions of trust, defendant Schapiro and each of the other individual defendants owed duties of candor, honesty, disclosure, fair dealing and loyalty to plaintiff and members of the Class in carrying out the business operations and governance of the NASD.

20. Defendant Richard F. Brueckner is an individual who is a citizen of the State of Virginia. He is the Presiding Governor of NASD's Board of Governors. Like Ms. Schapiro, he has been actively involved in promoting the transaction.

21. Defendant Barbara Z. Sweeney is an individual who is a citizen of the District of Columbia. She serves as NASD's Senior Vice President and Corporate Secretary. On information and belief, she, too, has been actively involved in promoting the Transaction.

FACTUAL BACKGROUND

22. On November 28, 2006, NASD and NYSE announced the Transaction — a plan to consolidate their member regulation operations into a combined organization that will be the sole U.S. private-sector provider of member firm regulation for securities firms doing business with the public. The combined organization would be responsible for all member firm regulation, arbitration and mediation, and all other current NASD responsibilities, including market regulation by contract for NASDAQ, the American Stock Exchange, and the

International Securities Exchange. In addition, the combined organization will be responsible for the professional training, testing and licensing of registered persons, and industry utilities, such as Trade Reporting Facilities and other over-the-counter operations. At the Closing of the Transaction, now estimated to take place on or after June 1, 2007, NASD will adopt a new corporate name. The newly-named entity is referred to herein as the "New SRO."

23. The Transaction requires NASD to amend its by-laws. That by-law change requires a *valid* vote by a majority of NASD membership. Defendants, for reasons set forth below, rushed to consummate the Transaction in order, in part, to avoid NASD's 2007 Annual Meeting of members and, more significantly, the wrath of members of the Class and the election of Governors. Each of the defendants solicited votes of NASD members in support of the Transaction pursuant to a proxy statement dated December 14, 2006 (the "Proxy Statement"). Defendants did not disseminate the Proxy Statement to NASD members until December 14, 2006, the day before the beginning of Chanukah and shortly before Christmas. They scheduled a vote on January 19, 2007, shortly following the Holiday season.

24. The Proxy Statement concealed material facts with respect to the Transaction, including, *inter alia*, how, how long and why it was negotiated. The Proxy Statement was not a neutral, complete, candid or even straightforward portrayal of the facts relevant to the Transaction. It would flunk virtually every test under modern proxy law. The one-sided Proxy Statement does not even purport to describe the "downsides" of the Transaction to plaintiff and members of the Class or provide any analysis or description of alternative transactions pursuant to which regulatory consolidation could take place that were more beneficial to NASD members who are members of the Class. Rather, the Proxy Statement was replete with conclusory, one-sided statements and was of little, if any, value in describing the true nature and consequences of

the Transaction and how it was harmful to affected NASD members' interests. The Transaction was announced in a press conference with the Chairman of the Securities and Exchange Commission, and the announcement was followed by a national tour akin to the road shows that investment banks employ to tout securities offerings. Defendants used the threat of immediate SEC intervention in the absence of approval of the Transaction as a club to secure approval.

25. The proponents, including the three individual defendants, strongly touted the Transaction as promoting efficiencies in the regulatory process, a principal reason for the SEC's support of consolidation. The Proxy Statement does not spell them out, quantify them or explain such "efficiencies." Since such efficiencies are the stated basis for, *inter alia*, the financial "benefits" of the Transaction to plaintiff and the members of the Class, such details were material facts which were omitted from the Proxy Statement. Equally important, the Proxy Statement does not explain why the Transaction, as proposed by defendants, is the best means of achieving their stated goals, *e.g.* consolidating the regulatory functions of the two SROs. Providing few details, the Proxy Statement indicates that the Transaction will make private-sector regulation more efficient and effective. Although the Transaction is designed to accomplish the establishment of a single SRO to serve as the sole U.S. private-sector provider of member firm regulation for securities firms doing business with the public, such a consolidation could have been effectuated by alternative means far more advantageous to plaintiff and the members of the Class.

26. The Transaction is designed by its proponents to offer member firms, according to such proponents, the following purported "benefits":

- In connection with the Transaction, a one-time special member payment will be made to members in the amount of $35,000 per member;

- The Gross Income Assessment to members — a firm's annual dues to NASD — will be reduced by $1,200 per year for five years, subject to annual Board approval;

- It is expected that the New SRO will benefit from economies of scale and will be able to reduce regulatory fees starting in the third year after the closing of the Transaction; and

- The new governance structure guarantees industry participation that ensures fair and balanced member representation on the Board.

27. Following the consummation of the Transaction, NASD's "one firm, one vote" rule will be replaced by a 23-person Board of Governors elected as follows:

- Ten governors will be from inside the securities industry;

- Small firms (1-150 registered representatives) elect three seats;

- Mid-size firms (151-499 registered representatives) elect one seat;

- Large firms (500+ registered representatives) elect three seats;

- Three appointed industry seats: one each for NYSE floor members, independent dealers/insurance affiliates and investment company affiliates;

- Eleven governors will be appointed from outside the securities industry;

- The Chief Executive Officer will serve on the Board of Governors;

- The Chief Executive Officer of NYSE Regulation, Inc. will serve on the Board of Governors for a three-year transitional period, after which such seat automatically will be terminated and the authorized number of members of the Board will be reduced by one.

28. A fundamental aspect of the Transaction requires that the NASD by-laws be amended to implement the new governance structure of the New SRO, which is heavily skewed toward the larger members firms, particularly those which are also NYSE members. Indeed, even the foregoing definition of "small firms" was selected by the defendants to favor larger firms against the interests of most members of the Class, which are truly "small firms" having far fewer than 150 registered representatives.

29. In fact, while the Transaction seems to have surface appeal, it is the consolidation of two entities with very different memberships and interests. Unlike the NYSE, the NASD has many truly small and medium sized firms. These firms operate under the "one firm, one vote" rule in electing NASD's Board of Governors, which governs or manages the NASD. Of the approximately 5,100 NASD members, only about 200 of the largest are members of the older NYSE.

30. The Transaction is unfair to NASD members which are members of the Class on both economic and governance grounds. As to governance, the Transaction is unfair to the extent that NASD members, despite the greater size of the membership of NASD as compared to NYSE, will have their influence over the New SRO substantially diluted, leaving control of it, *de facto*, in the hands of the member firms of the NYSE and the individual defendants who, in practical terms, will be in a position to control the appointment of the Governors from outside the securities industry and, thereby, dominate and control the New SRO.

31. On economic grounds, the 5,100 members of NASD have a huge stake in the assets of NASD, including the approximately $1.5 billion from the sale of NASDAQ. According to some estimates, the per member allocation should have been $135,000, or more. The only monetary benefits that will flow to NASD members will be a one-time payment of $35,000 per member, regardless of size, term of membership or financial stake in NASD's assets, and a $1,200 per year reduction in the gross assessment per year for five years regardless of size or term of membership. Collectively these are referred to as "the monetary inducements." The source of the cash payment is the NASD members' retained equity. The Proxy Statement does not highlight this key fact.

32. For some small firms, the monetary inducements provided a strong financial incentive to vote "yes" on the proposed consolidation. This was so especially in light of the misleading explanation by the Transaction's proponents that, with respect to the "special member payment" of $35,000 payable on the closing of the Transaction, "[a] larger payment is not possible" because a higher payment could "seriously jeopardize" NASD's status as a tax-exempt organization. This deceptive statement completely obscures that the source of the payment is Members' Equity. The New York Times has openly questioned, "Is this a case of vote buying?" ("Let's Vote on Securities Rules. Oh, and Here's $35,000") (NYT 11/29/06). Similarly, the $1,200 per year flat assessment "is the minimum annual gross assessment charge." That is a meaningful financial incentive for small firms. The Proxy Statement does not:

* provide any opinion of tax counsel supporting the proponents' statements about the tax impact of alternative courses;

* provide any "fairness opinion" supporting the fairness of the transaction to NASD members;

* explain how the proponents arrived at the $35,000 figure, except to make the claim that the payment to be made at closing will be funded by the "expected" value of the incremental cash flows that will purportedly be produced by the Transaction;

* explain how the total payments of approximately $175 million to NASD members will be financed or that it is coming from the members' own equity;

* explain why the payment to NASD members is a flat payment;

* explain why it is being paid at Closing when it represents cost savings that will purportedly be achieved over five years;

* explain what, if any, consequences will result if the expected cost savings are not achieved;

* explain why the $1,200 per year payment was set at a number that exactly equals the annual gross assessment that approximately 2,400 NASD members pay;

* explain what will become of the NASD members' interest in NASD's equity; or

* explain whether alternatives for distributing that equity were considered, evaluated or discussed by or among the defendants.

33. The terms and conditions of the Transaction were assembled behind closed doors and were largely dictated by large securities brokerage firms which are members of both NYSE and the NASD with very little or no participation by NASD rank-and-file members. The SEC played no role in determining or approving the terms and conditions of the Transaction. The terms and conditions are manifestly unfair to those members of NASD which are not also members of NYSE. Indeed, before negotiating the Transaction and despite the requirements of applicable Delaware law, defendants specifically avoided or were negligent in not seeking opinions as to the fairness of the Transaction to the members of NASD, either from a financial point of view or otherwise. Additionally, defendants Schapiro, Brueckner and Sweeney, in negotiating such terms and conditions, essentially sacrificed the interests of those whom they were obligated to protect, *i.e.*, plaintiff and the members of the Class.

34. Despite the apparent manifest unfairness of the terms and conditions of the Transaction to NASD members who are members of the Class herein, NASD, acting through various of its member firms including, upon information and belief, Goldman Sachs, Pershing, ING and Sterne Agee, used the implied threat of withdrawal of business opportunities and other benefits to pressure NASD member firms which were economically dependent upon the NYSE

member firms to vote at or before the Special Meeting in favor of the Transaction even though a vote in favor of the Transaction was not in most NASD members' best interests.

35. In particular, had there been a fair allocation of the assets of NASD to plaintiff and the members of the Class, the per member allocation would and should have been approximately $135,000 each as compared to the $35,000 that will be received by them upon the consummation of the Transaction. Further, the Transaction is unfair to the extent that NASD members, despite the greater size of the membership of NASD as compared to NYSE, will have their influence over the New SRO substantially diluted, leaving control of it, *de facto*, in the hands of the member firms of the NYSE and the individual defendants. Instead of voting on all directors, NASD members will vote for only three of 23 directors, depending on their size. Further, defendants have defined "small firms" to include many that would objectively be regarded as "large," all of which was engineered by defendants to favor the larger member firms.

36. In order to obtain approval from the membership of the NASD, defendants caused to be issued and disseminated the Proxy Statement with respect to the voting upon the Transaction, which voting by NASD members was to and did take place at the Special Meeting.

37. Under Delaware law, membership approval of the Transaction, in addition to the by-law changes, was required. Yet in their rush to consummate the transaction, the defendants did not do this. Similarly, defendants intentionally did not include as part of the Proxy Statement the actual agreement between NASD and NYSE, which they were legally obligated to do under applicable Delaware law.

THE PROXY STATEMENT

38. The Proxy Statement was prepared jointly by NASD and NYSE and was disseminated to NASD member firms with a cover letter signed by defendants Schapiro and Brueckner and a formal Notice of the Special Meeting signed by defendant Sweeney.

39. With respect to the "special member payment" and other terms and conditions of the Transaction, the Proxy Statement represented at page 4:

> The consolidation will reduce the costs of regulation. In connection with the Transaction, a one-time special member payment will be made to NASD members. The special member payment will be $35,000 per NASD member. In addition, we will discount the annual gross income assessment to members for a period of five years, subject to annual Board approval. Each firm would receive a discount of $1,200 per year, which is the minimum annual gross income assessment charge and the total amount of the annual gross income assessment that approximately 2,400 member firms pay. As a result of this discount, the approximately 2,400 member firms currently paying the minimum would pay no gross income assessments charge over the five-year period. It is expected that we will benefit from economies of scale and will be able to reduce regulatory fees starting in the third year after the closing of the Transaction.
>
> Firms that today are regulated by both NASD and NYSE Regulation will benefit from the elimination of the current duplication of regulatory review of these firms. The Transaction will further benefit all NASD members as it will streamline the broker-dealer regulatory system, combine technologies, and establish organization — all of which will serve to enhance oversight of U.S. securities firms and help ensure investor protection. Moreover, we are committed to reducing regulatory costs and burdens for firms of all sizes through greater regulatory efficiency.
>
> As a result of the By-Law amendments, members will no longer have the ability to vote for all Board candidates in elections, but will have an opportunity to vote on designated seats on the Board. Specifically, firms will vote for industry nominees that are similar in size to their own firm. This means that small firms and large firms will vote for candidates running for the seats reserved for their firm size and the mid-sized firms will likewise vote for the mid-sized firm seat. All other Board seats will be appointed. All members will continue to have the ability to vote on any future By-Law amendments, as well as district elections. In addition, the New SRO will continue NASD's current practice of subject-matter expert standing committees and NASD's current notice and comment process for rule-making.

To further encourage small firm input and participation, NASD has enhanced the existing Small Firm Advisory Board by making half of the seats elected. The Small Firm Advisory Board will continue to review New SRO rules and make recommendations to the Board of Governors."

40. The Proxy Statement was accompanied by a form of proxy as well as instructions for the various means by which NASD members could vote upon the proposed Transaction.

41. The Proxy Statement, with the explicit knowledge of defendants and their respective legal counsel and advisors, was intended to and did deceive a majority of the members of NASD into believing that the Transaction was beneficial to them. Ultimately, due to the deceptive nature of the Proxy Statement as provided herein, together with the pressures put upon many of the smaller firms which are members of NASD by NYSE member firms, the Transaction was approved by what NASD claims was "a majority of a quorum" at the Special Meeting.

42. The Proxy Statement was skewed, implying that the "special member payment" of $35,000 was the maximum amount payable to NASD members due to NASD's status as a not-for-profit corporation and, in any event, because it and the other terms and conditions of the Transaction were purportedly fair to NASD members.

43. In fact, the Proxy Statement was materially deficient because, despite the explicit knowledge of the defendants, it:

a. failed to disclose that, in fact, defendants did not seek, in advance of negotiating the economic terms of the Transaction, an independent valuation of the NASD membership interests to be given up which, in the aggregate, were worth more than $1.6 billion;

b. failed to disclose that, in fact, the defendants did not seek, in advance of negotiating the governance and other terms and conditions of the Transaction, an independent valuation of the NASD membership rights to be given up, particularly by smaller firms;

c. failed to provide a complete or even consistent history of the negotiations or provide all the reasons for acceptance of the transaction;

d. failed to disclose that defendants elected not to include in the Proxy Statement opinions of taxation experts as to the propriety of paying NASD members more than $35,000 per membership or the views of the Internal Revenue Service with respect thereto because such opinions and views were, at best, ambiguous and not supportive of the statement in the Proxy Statement that appears at p. 7 in purported response to the question:

"Can NASD increase the amount of the $35,000 one-time special member payment?" And the answer:

"A larger payment is not possible. NASD is a tax-exempt organization and therefore is limited by tax laws regarding size and source of payments it can make to its members. The special member payment of $35,000 per NASD member, or approximately $175.0 million in the aggregate, will be funded by—and therefore limited by—the expected value of the incremental cash flows that will be produced by the consolidation transaction. If the special member payment was higher, it could seriously jeopardize NASD's status as a tax-exempt organization, which would result in significantly higher fees for firms."

e. failed to explain that the $35,000 payment comes from Members' Equity;

f. failed to disclose what the tax impact on NASD and its members would be if the NASD intentionally changed its status as a tax-exempt organization or otherwise lost it;

g. failed to disclose that defendants decided not to consider alternative transactions including, *inter alia*, one in which NASD would have given up its tax-exempt status, one which would otherwise have generated more than $35,000 per NASD member or one which would have transferred all of NASD's regulatory functions to the New SRO without collapsing NASD;

h. failed to disclose that and the extent to which, prior to the issuance of the Proxy Statement, NYSE member firms and NASD personnel were applying undue pressure to NASD member firms to approve the Transaction at or in connection with the Special Meeting, notwithstanding the fact that the Transaction would negatively impact NASD member firms not members of NYSE;

i. failed to disclose that NASD members' loss of rights to vote for all directors of the New SRO's Board of Directors was likely to have a negative impact upon the proclaimed long-term economics of the Transaction including, *inter*

alia, whether the elimination of the $1,200 annual fee or any other fee payable by NASD members beyond three years would be continued;

j. failed to disclose the NASD's belief that the Transaction benefited large firms at the expense of small ones; and

k. failed to disclose that a membership vote was required on the Transaction itself.

44. As a result of the false and misleading Proxy Statement as described herein and the other actions taken by all defendants, the suffrage rights of plaintiff and the members of the Class have been damaged.

VIOLATIONS OF DELAWARE CORPORATE LAW

45. Pursuant to Section 211 of the Delaware General Corporation Law, if the Annual Meeting for election of Governors of the NASD is not held on the date designated therefore (*i.e.* within 13 months from the last Annual Meeting in 2006) or action by written consent of the members to elect Governors in lieu of an Annual Meeting has not been taken, the Governors shall cause the meeting to be held as soon as is convenient. NASD's Governors have taken no such action.

46. Upon information and belief, the individual defendants caused the 2007 Annual Meeting of NASD to be put off in favor of the Transaction in the hope that the sitting Governors would not have to face re-election as well as the wrath of the members of the Class.

47. Inasmuch as there has been a failure to hold NASD's 2007 Annual Meeting on or before March 2, 2007, or to take action by written consent to elect Governors in lieu of the 2007 Annual Meeting for a period of 30 days after the date designated for the Annual Meeting, or if no date has been designated, for a period of 13 months after the latest to occur of the organization of the corporation, its last Annual Meeting (*i.e.* February 3, 2006) or the last action by written

consent to elect Governors in lieu of NASD's Annual Meeting, either this Court or the Delaware Court of Chancery may summarily order a meeting to be held upon the application of, *inter alia*, any member of NASD. The members of NASD represented at such meeting, either in person or by proxy, and entitled to vote thereat, shall constitute a quorum for the purpose of such meeting, notwithstanding any provision of the certificate of incorporation or bylaws to the contrary. Either this Court or the Delaware Court of Chancery may issue such orders as may be appropriate, including, without limitation, orders designating the time and place of such meeting, the record date for determination of NASD members entitled to vote, and the form of notice of such meeting.

48. Under Delaware law, the vote of the membership is required not only with respect to amendments to by-laws, but also on the consolidation agreement itself. Defendants failed to submit the Transaction for such a vote.

CLASS ACTION ALLEGATIONS

49. Plaintiff brings this action on its own behalf and as a Class Action under F.R.C.P. 23(b)(2) and (b)(3) on behalf of the members of the Class as defined below.

50. The Class consists of all persons who were members of the NASD and entitled to vote at the Special Meeting; excluding those members which were also concurrently members of NYSE. The definition of the Class is subject to amendment following discovery with respect thereto.

Numerosity

51. The members of the Class are so numerous that joinder of all members is impractical. While the exact number of members of the Class is unknown to plaintiff at this time, it appears that the Class includes approximately 4,900 persons or entities.

Typicality

52. Plaintiff's claims are typical of absent Class members' claims. Plaintiff and the members of the Class will be irreparably damaged if the Transaction is consummated and have sustained and will sustain damages in an identical manner. Further, their claims arise from the same factual background and legal theories.

Adequacy of Representation

53. Plaintiff will fairly and adequately protect the interests of absent members of the Class and has retained counsel competent and experienced in litigating complex litigation such as this case. Plaintiff's interests are coincident with, and not antagonistic to, the interests of absent members of the Class because, by proving its individual claims, plaintiff will necessarily prove defendants' liability as to the respective Class members' claims. Plaintiff is also cognizant of, and determined to, faithfully discharge its fiduciary duties to the absent members of the Class.

Superiority

54. A class action is superior to other available methods for the fair and efficient adjudication of this controversy. The expense and burden of individual litigation effectively makes it impossible for members of the Class to seek redress individually for the wrongs complained of herein.

Manageability

55. There are no unusual difficulties likely to be encountered in the management of this action as a Class Action that could not be managed by this Court. The advantages of maintaining the action as a Class Action far outweigh the expense and waste of judicial effort that would result in hundreds or thousands of separate adjudications of these issues for each member of the Class.

56. Class treatment further insures uniformity and consistency in results and will provide optimum compensation for members of the Class for their injuries and protects them from the irreparable harm that will befall members of the Class if the Transaction is consummated.

Universally Applicable Conduct

57. Relief concerning plaintiff's rights under the laws herein alleged and with respect to the Class would be proper. Defendants have acted or refused to act on grounds generally applicable to the Class, thereby making appropriate final injunctive relief or corresponding declaratory relief with regard to members of the Class as a whole and certification of the Class under Rule 23(b)(2) proper.

Predominance and Commonality

58. The questions of law and fact common to the claims of each member of the Class overwhelmingly predominate over any questions of law or fact affecting only individual members thereof. Questions of law and fact common to the Class include, but are not necessarily limited to, the following:

(a) Whether defendants disseminated a false and misleading Proxy Statement to NASD members to fraudulently or negligently induce them to vote in favor of the Transaction and whether, in connection therewith, plaintiff and the members of the Class have already been damaged;

(b) Whether plaintiff and the members of the Class have been and/or will be injured further if the Transaction is consummated; and

(c) What is the measure of the economic and non-economic damages that will be sustained by plaintiff and the members of the Class if the Transaction is consummated?

COUNT I

BREACH OF DUTIES OF CANDOR, HONESTY, DISCLOSURE, FAIR DEALING AND LOYALTY

59. Plaintiff repeats and realleges each and every allegation set forth above as though stated more fully herein.

60. The defendants to this Count are defendants Schapiro, Brueckner and Sweeney, each of whom, by virtue of their senior positions as executives and/or Governors of NASD, owes fiduciary duties to plaintiff and members of the Class. Such duties include, *inter alia,* the duties of loyalty, honesty and candor.

61. Delaware law requires defendants to disclose all material facts that would have a significant impact on the membership vote. Their issuance and dissemination of the Proxy Statement to plaintiff and the members of the Class did not satisfy such obligation.

62. By causing the terms and conditions of the Transaction to be negotiated as they were, and actively participating in such negotiations as the purported representatives of all the members of NASD, the individual defendants breached their duties owed to plaintiff and the members of the Class. By acting as they did, they were more interested in negotiating the Transaction, which, if consummated, will yield to them important employment and financial benefits from the New SRO at the expense of the interests of the members of the Class herein.

63. By participating in the drafting and the dissemination of the Proxy Statement, which they knew or should have known was materially deceptive, they breached their duties owed to plaintiff and members of the Class including, *inter alia*, the duty of candor.

64. As a result of the individual defendants' breaches of duty to them, plaintiff and members of the Class have already been damaged, will be irreparably harmed and will be

otherwise damaged in an amount which cannot presently be calculated if the Transaction is consummated.

COUNT II

NEGLIGENT MISREPRESENTATION

65. Plaintiff repeats and realleges each and every allegation set forth above as though stated more fully herein.

66. All defendants are defendants to this Count.

67. As indicated above, the Proxy Statement misrepresented material facts with respect to the Transaction and omitted other material facts that should have been disclosed in connection therewith.

68. In participating in the drafting and ultimately disseminating the Proxy Statement, each of the defendants negligently caused statements to be made therein which they knew or should have known would negatively impact NASD's corporate suffrage process and mislead members of the Class with respect to, *inter alia*, the Transaction and the circumstances surrounding its negotiation.

69. As a direct consequence of defendants' negligent misrepresentations of material facts in the Proxy Statement and omission of material facts therefrom, plaintiff and members of the Class have already been injured, will be irreparably harmed and will be otherwise damaged in an amount which cannot presently be calculated if the Transaction is consummated.

COUNT III

UNJUST ENRICHMENT

70. Plaintiff repeats and realleges each and every allegation set forth above as though stated more fully herein.

71. NYSE and the individual defendants are defendants to this Count.

72. If the Transaction is consummated, the defendants to this Count will be unjustly enriched at the expense of plaintiff and members of the Class. In the case of NYSE, upon the consummation of the Transaction, it and its members will inherit a substantial pool of assets and other tangible and intangible benefits not capable of being presently calculated, for which benefits it will not have paid to plaintiff or members of the Class fair consideration.

73. If the Transaction is consummated, defendants Schapiro, Brueckner and Sweeney will receive employment and other benefits beyond those to which they are entitled in their present roles with NASD. None of these additional benefits will have been earned by them but were and are, nevertheless, an important factor in the carrying out the roles that they did in connection with the Transaction.

74. Defendants voluntarily are accepting these benefits that are being conferred upon them involuntarily by plaintiff and the members of the Class and will be retaining such benefits unjustly should the Transaction be consummated.

75. Plaintiff and the members of the Class are entitled to damages as a result of the defendants' unjust enrichment, including the disgorgement of all monies unlawfully accepted and to be accepted and retained following consummation of the Transaction by defendants from New SRO and from plaintiff and the members of the Class, as well as the earnings thereupon.

COUNT IV

DENIAL OF RIGHTS UNDER DELAWARE CORPORATE LAW

76. Plaintiff repeats and realleges each and every allegation set forth above as though stated more fully herein.

77. As discussed above, and as relevant here, Section 211 of the Delaware General Corporation Law, requires the election of Governors of the NASD within 13 months from the last Annual Meeting, which was held on February 3, 2006. The Governors are required to cause the meeting to be held on or before March 3, 2007. NASD's Governors have taken no such action.

78. Upon information and belief, the individual defendants caused the 2007 Annual Meeting of NASD to be put off in favor of the Transaction in the hope that sitting Governors would not have to face a contested re-election and face the wrath of the members of the Class.

79. Inasmuch as there has been a failure to hold NASD's 2007 Annual Meeting and it has been over 13 months since the last Annual Meeting (*i.e.*, February 3, 2006), either this Court or the Delaware Court of Chancery may summarily order a meeting to be held upon the application of, *inter alia*, any member of NASD. The members of NASD represented at such meeting, either in person or by proxy, and entitled to vote thereat, shall constitute a quorum for the purpose of such meeting, notwithstanding any provision of the certificate of incorporation or bylaws to the contrary. Either this Court or the Delaware Court of Chancery may issue such orders as may be appropriate, including, without limitation, orders designating the time and place of such meeting, the record date for determination of NASD members entitled to vote, and the form of notice of such meeting. Plaintiff requests that the Court compel such a meeting and vote.

80. By this Count, plaintiff hereby makes application for such Order or Orders.

81. Plaintiff and members of the Class are entitled to have the Court Order NASD to schedule its Annual Meeting as soon as practicable and to Order a new election of Governors after affording members of the Class to nominate a slate of prospective Governors.

COUNT V

CONVERSION/TAKING

82. Plaintiff repeats and realleges each and every allegation set forth above as though stated more fully herein.

83. All Defendants have improperly converted the Class members' assets and/or Members' Equity for the use of the New SRO and NYSE without validly obtaining their consent.

84. Alternatively, if defendants are regarded as governmental actors (which plaintiff believes not to be the case), if the Transaction is consummated, then defendants will have "taken" the Members' Equity of the plaintiff and the Class without adequate compensation and without due process of law. As such, plaintiff and the members of the Class will have been damaged in an amount which cannot presently be determined.

COUNT VI

SUBSTANTIAL DIMINUTION OF VALUE IN MEMBERSHIP, WITH IMMINENT COMPLETION OF SUCH DIMINUTION

85. Plaintiff repeats and realleges each and every allegation set forth above as though stated fully herein.

86. All defendants are defendants to this Count.

87. The NASD is organized pursuant to Delaware law as a membership corporation to provide the services of regulation to plaintiff and members of the Class, without which each of

these members would lack access to the business opportunities of its field. Plaintiff and members of the Class must pay for their NASD services by dues which are substantially offset for them by the revenues from the NASD's "Member's Equity," which, as previously alleged, is in excess of $1.5 billion.

88. By the defendants' actions to date, the NASD's "Member's Equity" has declined in value.

89. Plaintiff and others Class Members have been and will be damaged in that they have not and will not receive their fair portion of the value of "Member's Equity" and have been and will be prevented from maximizing the value of the "Member's Equity" in the NASD if the Transaction is allowed to become effective.

90. The completion of the Transaction, and with it, the completion of the substantial diminution of value of the "Member's Equity" to plaintiff and members of the Class, is imminent.

COUNT VII

DEPRIVATION OF VOTING MEMBERSHIP

91. Plaintiff repeats and realleges each and every allegation set forth above as though stated fully herein.

92. All defendants are defendants to this Count.

93. The NASD is organized pursuant to Delaware law as a membership corporation. Its emphatically democratic "one member, one vote" organization represents much more than simply the governance style of a not-for-profit business, which might add or change voting classes of stock without materially altering its not-for-profit purpose. Rather, the NASD came into existence from the willingness of a previously unorganized community of predominantly

small businesses to govern its own affairs, and not cede the control of that community to the very different firms which control the NYSE. From its outset, the NASD remained organized and operated along democratic lines with the encouragement of the Congress. This effectively amounted to a democratic way of life for the NASD community, allowing it to pioneer countless innovations, from no-minimum commissions to the electronic trading exchange. The presence of public members on the NASD Board has not altered the within-the-industry balance that the NASD has remained a democratic organization in which the predominantly small businesses could continue to govern its affairs without dominance by an otherwise unstoppable NYSE-centered oligarchy.

94. Under Delaware law, defendants' duty of candor in any proxy solicitation about a major corporate transaction or change in control was heightened by this Transaction's effect in substantially depriving plaintiff and the members of the Class of their "one member, one vote" voting participation in electing governing members of the Board of Governors.

95. Plaintiff and other Class Members have been and will be damaged in that they have been substantially diluted in their ability to control the future direction of the NASD.

96. By reason of the foregoing, Plaintiff and each Class Member will suffer irreparable injury absent injunctive relief.

PRAYER FOR RELIEF

WHEREFORE, plaintiff demands judgment against the defendants as follows:

a. certifying this action as a Class Action, with plaintiff and its counsel as the representatives of the Class;

b. declaring pursuant to 28 U.S.C. § 2201 that the Proxy Statement and solicitation did not comply with Delaware law;

c. ordering an accounting of the plaintiff and Class members' "Members' Equity;"

d. enjoining defendants from consummating the Transaction;

e. declaring the actions of defendants illegal and otherwise violative of the rights of plaintiff and the members of the Class;

f. ordering the holding of NASD's 2007 Annual Meeting of members as soon as practicable and, in connection therewith, affording the members of the Class the opportunity to propose a slate of nominees for the open governorships of NASD;

g. enjoining defendants from effectively disenfranchising members of the Class from the corporate governance of New SRO following the consummation of the Transaction, should the Court permit it to proceed;

h. ordering the preparation of a proxy statement which fully and adequately discloses all material facts and which provides for a new special meeting of members of NASD to be held under supervision of the Court;

i. awarding to plaintiff and the members of the Class compensatory and punitive damages as appropriate;

j. requiring defendants to account for their unjust enrichment and requiring them to pay over the amount thereof to plaintiff and the members of the Class together with the earnings thereupon;

k. awarding plaintiff its costs of suit, including reasonable attorneys' and experts' fees; and

l. such other and further relief as is just and proper.

JURY TRIAL DEMAND

Plaintiff hereby demands a trial by jury on all Counts so triable.

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Dated: April 9, 2007.

to be Filed
April 10, 2007

CUNEO GILBERT & LADUCA, LLC

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CERTIFICATE OF SERVICE

I hereby certify that on this 9th day of April, 2007, I caused to be served this Amended Complaint upon the following persons by email:

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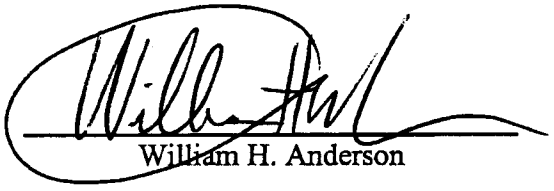

William H. Anderson

ATTACHMENT "D"

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

STANDARD INVESTMENT CHARTERED, INC., on behalf of itself and all others similarly situated,	
Plaintiffs,	Case No. 07-cv-2014(SWK)
v.	
NATIONAL ASSOCIATION OF SECURITIES DEALERS,INC. (a/k/a "NASD"); NYSE GROUP, INC.; MARY L. SCHAPIRO; RICHARD F. BRUECKNER and BARBARA Z. SWEENEY	**CLASS ACTION**
	JURY TRIAL DEMANDED
Defendants.	

REDACTED VERSION OF
PLAINTIFF'S MEMORANDUM OF LAW IN OPPOSITION
TO DEFENDANTS' MOTIONS TO DISMISS
PLAINTIFF'S AMENDED COMPLAINT

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PRELIMINARY STATEMENT

The Amended Complaint challenges Defendants' failure to comply with Delaware law governing corporate decision-making in soliciting support for a regulatory consolidation ("the Transaction") between the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange ("NYSE") that would end the NASD as it now exists. It alleges that the NASD Proxy Statement and Defendants' accompanying representations were not accurate, fair, informative, or complete. It challenges the manner in which Defendants represented and secured support for the Transaction. It seeks damages for proposed class members— *i.e.*, NASD members who are not also NYSE members. The basics of the Transaction are amply described in the Amended Complaint and Defendants' motions to dismiss.

For nearly 60 years, NASD members have lived by a "one member, one vote" rule. The democratic NASD has been extraordinarily successful. NASD's 2005 Annual Report reflects "Members' Equity" of over $1.5 billion, with cash and cash equivalents of $296,057,000 and investments of over $1.9 billion.[1] Exhibit 1 to Declaration of Jonathan W. Cuneo ("Ex. 1"), NASD 2005 Annual Financial Report at 30. Much of this comes from the sale of the NASDAQ stock exchange. That Report states that it was prepared in accordance with the Sarbanes-Oxley Act of 2002 and that NASD's financial statements were audited by Ernst & Young. *See id.* at 25.

Defendants now profess they do not owe duties of honesty to the approximately 5100 NASD members. The facts belie that astonishing effort to evade responsibility. The

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[1] Exhibit 1 is replete with references to "Members' Equity" (highlighted in the exhibit). There are more than a dozen references in the 117 page report.

NASD has treated its members with the trappings of fiduciary responsibility—issuing audited financial reports describing the extent of, and annual changes to "Members' Equity," and affording dues rebates from time to time. The NASD Proxy Statement directly acknowledge a duty to speak with candor: "We are committed to full disclosure and answering member questions about the consolidation plan and its implementation . . . ." Ex. 3, NASD - Regulatory Consolidation – Assertions and Facts at 3.

The Amended Complaint alleges, among other things, that:

1. *The Proxy materials misinform members that the one-time $35,000 payment is the largest payment possible to NASD members. See, e.g.,* Complaint ¶¶ 31-32, 35. The $35,000 payment and the five-year annual dues credit of $1,200 are the core incentives for small NASD members to vote "Yes" on the Transaction. *See* Complaint ¶ 31. Nearly all of the statements concerning this topic are inadequate, misleading, deceptive, or false. *See, e.g.,* Complaint ¶¶ 42-43. For example, the Proxy states: "*Q: Can NASD increase the amount of the $35,000 one-time special member payment?* A: A larger payment is not possible. NASD is a tax-exempt organization and therefore is limited by tax laws regarding size and source of payments it can make to its members." Ex. 2 at 7. A payment of $35,000 to each of approximately 5,100 totals roughly $178 million.

IRS revenue rulings indicate more could be paid (*e.g.*, as refunds of dues previously paid) without jeopardizing the tax-exempt status. *See* IRS Rev. Rul. 81-60, 1981-1 C.B. 335; IRS Rev. Rul. 77-206, 1977-1 C.B. 149; *King County Ass'n of Ins. Agents v. Commissioner*, 37 B.T.A. 288 (1938), *acq.* 1938–1 C.B. 17 (IRS 1938). Indeed, NASD has paid out sizeable dividends to members without losing its tax-exempt status.

REDACTED

REDACTED

2. *The Proxy Statement misrepresents the source of the $35,000 payment.* NASD Members will receive a one time $35,000 payment, the source of which, according to the Proxy Statement, is "the expected value of incremental cash flows" to be achieved by the consolidation. Ex. 2 at 7. The Amended Complaint alleges, consistent with NASD's statements, *see* Floyd Norris, *Let's Vote on Securities Rules. Oh, and Here's $35,000*, *N.Y. Times*, November 29, 2006, at C6, that the real source of the payment is the NASD's "Members' Equity." *See* Complaint ¶ 32.

REDACTED

3. *The Proxy repeatedly misstates the core nature of the Transaction.* Under Delaware law, a consolidation requires a shareholder vote on the transaction; an asset purchase does not. The Transaction is repeatedly and misleadingly billed as a consolidation of two entities into a new Self-Regulatory Organization ("SRO") in the Proxy Statement. *See* Ex. 2, Proxy Statement at 1, 4, 6-7, 13-14, 22.[3] Defendants now say that the form of the Transaction is an NASD purchase of regulatory assets of the NYSE. *See* NASD Br. 32. Yet the Transaction effects a change of control of the *acquiring* entity, which is more indicative of a merger or other form of consolidation than a simple purchase of assets. Under Delaware law, the Transaction itself should have been put to a member vote. It was not.

4. *The threat of SEC intervention was used as a club to coerce the NASD members to vote "Yes."* The Proxy materials stated: "There is every reason to believe that if the By-Law amendments are not approved by the NASD membership, and the Transaction does not close, the SEC will make its own decision about the structure and governance of SROs." Ex. 2 at 7. This threat is certainly material. If true, it requires explanation and documentation so that the members can reach an informed decision regarding the Transaction.

5. *The history of negotiations is inconsistent and incomplete.* The Proxy Statement makes a point of explaining that although negotiations began in June 2006, no discussion of consolidation occurred then, and it implies that discussions of consolidation

[3] According to the Proxy Statement, upon the completion of the Transaction the NASD shall cease to exist, and the New SRO will possess all the powers, rights, and privileges that the NASD had as well as be "subject to all the restrictions, disabilities and duties" of the NASD; the New SRO will also own all of the NASD's property, real, personal and mixed, and debts. Similarly, all rights of creditors and all liens upon property are preserved unimpaired and become attached to the New SRO. *Cf.* 8 DGCL § 259.

did not occur until November 2006. "A determination was made that the scope of the discussions should be limited to eliminating redundant member regulation and not to combine the market regulatory responsibilities of NASD and NYSE Regulation. Those meetings continued through November 2006." Ex. 2 at 13. At another point, however, the Proxy Statement says that the Board considered consolidation in September: "In September 2006, the Board of Governors of NASD met to review the proposed outline of the Transaction." Both of these statements cannot be true.

6. The Proxy Statement either inadequately describes or misrepresents the role of independent advisors in the decision to support the Transaction. The Proxy Statement discloses that the NASD retained an "independent third-party financial advisor to determine whether the consideration to be paid by NASD in the Transaction is fair" and stated that the Transaction is financially neutral. Ex. 2 at 11. The Proxy Statement does not indicate, however, how the financial advisor viewed the Transaction as to its fairness to NASD members. If any such fairness opinion existed before the Board vote, it was not incorporated into the Proxy Statement. According to the NASD's filing with this Court, it neither obtained such advice nor formed any such relationship with an independent financial advisor. *See* NASD Br. at 22 ("there is no requirement that a corporate board disclose advice it does not obtain or relationships it does not form). The Proxy Statement was thus materially deceptive by informing members, in language designed to mislead, that the Transaction was "fair" and based on advice from an expert whom the NASD now proclaims was never retained and never provided such advice.

ARGUMENT

I. APPLICABLE LEGAL STANDARDS

A motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6) should not be granted unless "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). The complaint must provide only "'a short and plain statement of the claim' that will give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests." *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 346 (2005) (quoting *Conley*, 355 U.S. at 47). "Given the Federal Rules' simplified standard for pleading, '[a] court may dismiss a complaint only if it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations.'" *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 514 (2002) (quoting *Hishon v. King & Spalding*, 467 U.S. 69, 73 (1984)).

As for Fed. R. Civ. P. 12(b)(1), Plaintiff accepts NYSE's description of the governing standard, but adds that additional discovery is sometimes necessary to respond adequately to a defendant's 12(b)(1) motion, and, when necessary, a district court may delay resolution of the jurisdictional issue until trial. *See, e.g., Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1131 (2d Cir. 1976); *Lawrence v. Dunbar*, 919 F.2d 1525, 1529-30 (11th Cir. 1990). Sometimes it is actually necessary to await trial to resolve them. *See, e.g., Alliance for Envtl. Renewal, Inc. v. Pyramid Crossgates Co.*, 436 F.3d 82, 88 (2d Cir. 2006), because the factual determinations on which their resolution depends necessarily merges with the underlying issues on the merits. *See, e.g., Pyramid*, 436 F.3d at 88; *Morrison v. Amway Corp.*, 323 F.3d 920, 929-30 (11th Cir. 2003); 5A Wright & Miller, FEDERAL PRACTICE AND PROCEDURE § 1350, at 235 (2d ed. 1990); *see also Land v. Dollar*, 330 U.S. 731, 739 (1947) ("The District Court has jurisdiction to determine its jurisdiction by proceeding to a decision on the merits."). While here discovery will no

doubt result in the development of a factual record relevant to the jurisdictional issue—and will, Plaintiff anticipates, only serve to reinforce Plaintiff's position on jurisdiction[4]—the existing record is more than adequate to support the Court's exercise of jurisdiction. Plaintiff establishes below that the case law governing ripeness, exhaustion, and immunity forecloses Defendants' jurisdictional arguments as a matter of law.

II. PLAINTIFF'S CLAIMS DO NOT REQUIRE SEC EXHAUSTION

Defendants' exhaustion challenge is without merit, as plainly shown by how each of the seven counts of the Amended Complaint arises out of Delaware (or New York)[5] corporate law rather than the federal rules promulgated under the federal securities laws:

- Count I alleges that Defendants breached their duties of loyalty, honesty, and candor by the Transaction and Proxy Statement—duties of the governors and senior management of a state-chartered corporation classically arising out of state (Delaware) law.[6]

- Counts II and III allege that Defendants negligently misrepresented in, and omitted materials facts from, the Proxy Statement, as well as unjustly enriched themselves—violations of state law governing the board of a Delaware-chartered corporation.[7]

- Counts V and VI allege that Defendants converted the NASD Members' Equity and are diminishing the value of membership—violations of state (Delaware) law governing the equity and value of NASD membership in a Delaware-chartered corporation.[8]

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[4] At the Court's request, Plaintiff will supplement the factual record supporting the Court's jurisdiction following the completion of the relevant discovery.

[5] Although this brief focuses on Delaware law, it is possible that some of Defendants' conduct could be judged under the laws of other states—including, in particular, the laws of New York.

[6] *See, e.g., Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). The citations here are included merely to adumbrate the state-law roots of each count of the Amended Complaint and not as a full statement of the pertinent state law.

[7] *See, e.g., Lynch v. Vickers*, 383 A.2d 278 (Del. 1977).

[8] *See, e.g., Paramount Communications Inc. v. QVC Network*, 637 A.2d 34 (Del. 1994).

- Counts IV and VII allege that Defendants substantially deprived the members of their voting ability—a violation of state (Delaware) law governing a Delaware-chartered corporation—and violated the Delaware General Corporation Law (DGCL) in failing to hold a NASD annual meeting within the statutorily mandated period.[9]

A. Federal Securities Regulations Do Not Supplant State Corporate Laws.

Courts have consistently followed Congress's lead in preserving and maintaining intact the body of state law governing matters of corporate governance, notwithstanding the important role that the federal securities laws play in regulating corporate conduct. *See e.g.*, 5 U.S.C. § 78bb(a) (preserving "all other rights and remedies that may exist at law or in equity"); *Matsushita Elec. Indust. Co., Ltd v. Epstein*, 516 U.S. 367 (1996); *Sante Fe Indust., Inc. v. Green*, 430 U.S. 462, 472-73 (1977). *See generally CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 86 (1987) (explaining that there is a "longstanding prevalence of state regulation in [the securities area] . . . that, if Congress had intended to preempt . . . it would have said so explicitly"). In *Matsushita*, for instance, the Court upheld a state judgment settling shareholders' claims and rejected the defendants' contention that the claims were supplanted by the federal securities laws: "Congress plainly contemplated the possibility of dual litigation in state and federal courts relating to securities transactions." 516 U.S. at 383. Countless other cases are in accord with *Matsushita*.[10] In fact, Delaware

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[9] *See, e.g., Carapico v. Philadelphia Stock Exchange, Inc.*, 791 A.2d 787, 790 (Del. Ch. 2000) (statutory rights of member of nonstock Delaware corporation and SRO do apply to stock exchange member); *Carter v. Glen Burnie Volunteer Fire Co.*, 438 A.2d 278 (Md. 1981) (member voting requirements not met in dissolution of nonstock company).

[10] *See, e.g., Diamond Multimedia Sys., Inc. v. Superior Court*, 968 P.2d 539, 552 (Cal. 1999); *Roskind v. Morgan Stanley Dean Witter & Co.*, 80 Cal.App.4th 345, 352 (2000). When the D.C. Circuit in *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990), held that the SEC exceeded its authority in prescribing rules of corporate stockholder voting rights pursuant to §78s, it quoted the Court's statement in *Santa Fe Industries* about how it is "reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden." 905 F.2d at 414.

has shaped its state corporate law around the principle that "[t]he historic roles played by state and federal law in regulating corporate disclosures have been not only compatible but complementary." *Malone v. Brincat*, 722 A.2d 5, 11-13 (Del. 1998) (strongly confirming the "fiduciary duty of directors in connection with disclosure violations" and its requirement of "complete candor" to the shareholders).

The regime of SEC-directed self-regulation by the NASD and the exchanges present no special exception. Declining to bar a state class action in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117 (1973), even though an NYSE rule required arbitration of the claims, the Supreme Court emphasized that the exchanges remain subject to state law:

> Congress intended to subject the exchanges to state regulation that is not inconsistent with the federal Act. Section 6(c), 15 U.S.C. §78f(c), explicitly subjects exchange rules to a requirement of consistency with the Act "*and the applicable laws of the State in which (the exchange) is located.*"

414 U.S. at 137 (emphasis added).[11] The Court cited the key federal securities law provision under which the rights and remedies provided by the securities act "shall be in addition to any and all other rights and remedies that may exist at law or in equity." *Id.* at 138 (citing 28 U.S.C. §§78bb(a) and (b)). Of particular importance here, the Court emphasized that "a stock exchange is organized as an association in accordance with the laws of the State of its location." *Id.* at 117.

B. State Corporate Law Plays an Important Role in the Governance of SRO's, Especially with Respects to Mergers, Proxy Solicitations, and Related Matters.

[11] The case law has interpreted the statutory reference to the law of the state in which the exchange is located to mean the state law made applicable by the governing conflicts-of-laws principles; hence for issues such as the duties of the board of directors, the provision refers to the state of incorporation.

Defendants attempt to contrive an exception to the settled rules governing the role of state law in core matters of corporate governance. They contend that the securities association (NASD), like a stock exchange (all of which are self-regulating organizations or SROs), although conceded to be corporations chartered pursuant to Delaware corporate law, *see* NASD Br. at 15-17; NYSE Br. at 17-19, occupy a special position under the Exchange Act that insulates them from state-law suits like this one. Defendants could not be more wrong.

It is not surprising that, for all of their self-righteous indignation, Defendants fail to cite a single case that supports their position. Each one of Defendants' cited cases quite unsurprisingly involves avoidance efforts by those who face SRO federal securities law disciplinary or de-listing proceedings or the like. None involves claims remotely similar to those here. None concerns manipulation by misrepresentation or omission of material facts in the context of a proxy solicitation. Quite the contrary, the cases cited by Defendants establish, as Plaintiff contends, that "under certain circumstances section 78aa may confer jurisdiction on the district court to entertain suits against the NASD." *First Jersey Sec., Inc. v. Bergen*, 605 F.2d 690, 694 (3d Cir. 1979) (internal quotations and citations omitted).

Just two years ago, a court within this district considered, and rejected, contentions by Defendant NYSE that were closely similar in their states-rights nature to those made by Defendants here. In *New York v. Grasso*, 350 F. Supp.2d 498 (S.D.N.Y. 2004), decided by Judge Lynch, the former chairman and CEO of the NYSE and the NYSE itself were sued for state-law corporate governance violations arising from the activities of the NYSE. The defendants contended that the case could not proceed in a usual judicial forum for such

state law violations, but must proceed only in a federal securities law forum. Rejecting this contention, Judge Lynch explained:

> As thus summarized, it is not apparent that the complaint states any claim under federal law or implicates any question requiring the interpretation of federal law. . . .
>
> No reference is made [in the complaint] to federal law, and it is difficult to see how federal law could play any role in deciding the case. No principle of federal law must be referred to in order to decide . . . . *Nor is there any apparent reason to believe that federal law shields . . . [what was] voted by conflicted or uninformed directors of [the NYSE].*

350 F. Supp.2d at 501-502 (emphasis added). Likewise, the court considered and rejected similar arguments by defendants on the ground that "'even though the alleged misconduct overlaps with conduct that is likewise proscribed by NYSE rules,' the plaintiff 'seeks only to enforce state law.'" 350 F.Supp.2d at 504 (citations omitted).

Moreover, in *Grasso* the court emphasized the significance of how Title 15 of the U.S. Code prescribed that the NYSE and the NASD shall organize under New York or Delaware (or other state) law, thereafter to have transgressions adjudicated by the courts—rather than exclusively by the SEC—pursuant to that state law:

> To the contrary, federal law, for now, leaves the NYSE to organize its governance in accordance with state law. *See* 15 U.S.C. §78c(a)(1) (defining "exchange" as "any organization, association or group of persons, whether incorporated or unincorporated").

Id. at 505-506. The court then distinguished the very cases Defendants cite here involving complaints relating to an Exchange's (including those of the NASD) disciplinary actions, enforcement functions and the like. *See* 350 F. Supp.2d at 507 (emphasizing that the "Second Circuit fully supports this conclusion.").[12] Picking up from *Grasso*, the ensuing

[12] *Grasso* discusses *D'Alessio v. NYSE*, 258 F.3d 93 (2d Cir. 2001) ("The NYSE's actions in that case related directly to the interpretation and enforcement of federal securities regulations," not New York or

state court proceeding against the NYSE CEO denied defendant's motion to dismiss, finding no difficulty adjudicating the NYSE's violations of its members' state corporate law rights with full awareness of federal regulatory authority. *See People ex rel. Spitzer v. Grasso*, 12 Misc.3d 384, 392, 816 N.Y.S.2d 863, 2006 N.Y. Misc. LEXIS 484 (N.Y. Sup. March 15, 2006).

In sum, the Supreme Court preserved state corporate law in *Merrill Lynch* and *Matsushita*, and Judge Lynch preserved this law specifically for the NYSE (and, hence, other SROs such as the NASD) in *Grasso*. Defendants struggle unpersuasively against this by speciously arguing that this federal administrative approval supplants or displaces the adjudication of state corporate law violations.[13]

The Supreme Court has addressed and answered Defendants' twisted kind of reasoning when another regulated-industry company tried to raise its administrative approval for a merger as a barrier to a suit based on misrepresentation to the voting shareholders. The Supreme Court held otherwise, upholding the shareholder misrepresentation suit without regard to the administrative approval. *See SEC v. National Securities, Inc.*, 393 U.S. 453 (1969). *National Securities* consigned full authority to the judicial proceeding—like this Amended Complaint—about the misrepresentation to the shareholders, even to the remedy to "order a return to the status quo ante [prior to the merger vote]," 393 U.S. at 464, notwithstanding the administrative regulatory approval of

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Delaware state law) and *Barbara v. NYSE*, 99 F.3d 49, 59 (2d Cir. 1996) ("the court found the NYSE immune for actions taken in disciplinary proceedings mandated by federal law," not as to New York or Delaware state corporate law issues). *See Grasso*, 350 F. Supp.2d at 507.

[13] *See, e.g., Wylain, Inc. v. TRE Corp.*, 412 A.2d 338, 344 (1979) (rejecting federal law challenge to Delaware corporate law: "Delaware has a legitimate public interest in affording . . . the protections afforded by the Delaware General Corporation law.").

the merger. As the Court reasoned in that case, "[p]resumably, full disclosure would have avoided the particular [nondisclosure] violations alleged in the complaint." *Id.* at 462-4633. "*The gravamen of the complaint was the misrepresentation, not the merger.*" *Id.* at 462 (emphasis added). In this case, too, the gravamen of the Amended Complaint is the misrepresentation, not the merger. *A fortiori*, a suit under Delaware law alleging a misrepresentation to voting members may proceed concomitant with a regulatory review process testing whether a regulatory consolidations of NASD and NYSE is acceptable.[14]

C. Recent State Law Cases Against NYSE and PHLX Undercut Defendants' Position.

Time and again, recent state law cases just like this one have gone ahead, even though they involved Exchange mergers or transactions. In *Ginsburg v. Philadelphia Stock Exchange, Inc.*, Civ. A. No. 2202-N (Del. Ch. Dec. 7, 2006) (Ex. 6), for instance, the Delaware Chancery Court rejected a motion to dismiss filed by the Philadelphia Stock Exchange (PHLX), a Delaware corporation and SRO (like the NASD). Plaintiff, a seat owner and stockholder, sued on behalf of a class of PHLX stockholders, alleging that the PHLX defendants breached their fiduciary duties in the course of a sale of control it. (The PHLX raised the business judgment rule as a ground to dismiss the Delaware state law suit, but without success.)[15]

Delaware law has traditionally handled the rights of members of the Exchange *qua* members, such as with respect to inspection of the Exchange's books, as a regular issue of

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[14] Moreover, it is no support for Defendants' exhaustion argument that the case involves proxy solicitations. "It must be remembered that a dissatisfied stockholder is free to litigate proxy-solicitation questions judicially, with or without prior administrative resort to the staff or the Commission." *Kixmiller v. SEC*, 492 F.2d 641 (D.C. Cir. 1974).

[15] Plaintiff's answering brief in opposition to defendants' motions to dismiss appears at 2006 DE Ch. Ct. Motions 2202, 2006 DE Ch. Ct. Motions LEXIS 1794 (Sept. 14, 2006).

state corporate law. *See, e.g.*, *Carapico v. Philadelphia Stock Exchange, Inc.*, 791 A.2d 787 (Del. Ch. 2000) (member inspection of books); *Bove v. PBW Stock Exchange, Inc.*, 382 So. 2d 450, 453 (Fla. 1980) (suit by member against predecessor of PHLX) (exchange's "officers and directors stand in a fiduciary relationship to the shareholders (members) and are bound to exercise the highest degree of fidelity and fairness in all their dealings with them").

Nothing so illuminates the appropriateness of this state-law case involving one of the NYSE's current mergers than the state-law cases involving its previous one. The other way the NYSE has recently reshaped the stock exchange field has been its merger with Archipelago. Nothing could better illustrate the application of state law to govern such NYSE mergers than the series of court cases about the NYSE-Archipelago merger. In the recent decision of *In re New York Stock Exchange/Archipelago Merger Litigation*, 824 N.Y.S.2d 764, 2005 N.Y. Misc. LEXIS 3184 (N.Y. Sup. 2005), plaintiff members of the NYSE challenged the merger of the NYSE and Archipelago on state corporate law grounds such as breach of fiduciary duty and of loyalty. Plaintiffs sought a preliminary injunction; defendants moved to dismiss. The court denied the motion to dismiss, and held a hearing with witnesses on the preliminary injunction.

On the second day of testimony, the parties agreed to a settlement requiring selection of an independent financial expert, subject to plaintiffs' consent, to render an opinion on the fairness of the proposed merger, to provide a sound basis for the members' vote to follow. *Id.* Deficiencies in the fairness report led to an additional report by plaintiffs' consultant. *Id.* Of course, a central aspect of the proposed NYSE-NASD Transaction that is the subject of this litigation, pleaded properly in the Amended

Complaint, consists of similar NYSE-NASD shenanigans in place of a proper fairness opinion, properly disclosed. Defendants' proxy solicitation alluded to consultations by Defendants with an independent financial expert— fairness opinions by an independent financial expert have become standard in such matters—but Defendants' filings now say before this Court that (at least before the NASD vote to approve the change in the NASD By-Laws) no fairness opinion was sought and no consultant retained.[16] *See* NASD Br. at 22. The preliminary injunction hearing in this case will thus bear more than a family resemblance to the one on the NYSE's other flawed preparations for a merger vote, which led it to accept a judicial order regarding the fairness opinion needed in that matter.

Furthermore, in approving a class settlement, the court reviewed the previous NYSE merger and looked favorably upon the suit's merits, recapitulating the reasons it had denied the motion to dismiss. It concluded that "this Court finds plaintiffs' claims seeking further disclosure were likely to be meritorious." *Id.* It seems unlikely that the NYSE would submit to that preliminary injunction hearing and to that disclosure order suiting plaintiff if it had a colorable basis for arguing that suits like that one and this one—state law suits about disclosure violations before merger votes—require SEC exhaustion. More realistically, the NYSE knew then, and must know now, that such claims require a judicial resolution on the merits.

Another opinion issued just this month, *Wey v. NYSE*, No. 602510/05 (N.Y. Sup. April 10, 2007) (Ex. 5), deals with another state law case brought by a member against the NYSE relating to its merger with Archipelago. There plaintiff alleged that the NYSE's

[16] Indeed, the absence of such an opinion as to the fairness of the Transaction is, as a matter of Delaware law, evidence of a fundamental breach of fiduciary duty. *See, e.g., Smith v. Van Gorkum* , 488 A.2d 858 (Del. 1985).

CEO gave misleading information about the status of the merger to a group of seatholders. Following state law, the court denied the motion for summary judgment as to that misrepresentation cause of action, concluding that "if a fiduciary chooses to disclose information to shareholders, it must be accurate, complete, and not misleading." Slip op. at 18. As a parallel case discusses, the SEC approved the merger on February 27, 2006, and the merger closed on Mar 7, 2006. *See Hyman v. NYSE*, No. 600709/06, 2007 N.Y. Misc. LEXIS 143 (N.Y. Sup. Jan. 10, 2007). In that case, too, the allegation of misleading disclosure to the member was not subject to a motion to dismiss.

In neither *Wey* nor *Hyman* does it appear that the NYSE could protect itself from the lawsuit by arguing that such state law issues (the merger of an SRO based on faulty disclosures to members) are for the SEC rather than the courts. Likewise, in *In re New York Stock Exchange/Archipelago Merger Litigation* the SEC did not have exclusive authority over the merger of the SRO. Equally, here, there is no basis for excluding the Court from addressing properly pleaded state corporate law claims involving the same kind of transaction with similar kinds of faulty disclosure. Exhaustion is just not required.

III. PLAINTIFF'S LAWSUIT IS RIPE FOR ADJUDICATION BY THIS COURT

The allegations of the Amended Complaint arise from Defendants' breach of various fiduciary and related duties owed to Plaintiff and members of the class—including the allegedly improper proxy solicitation and Defendants' actions in structuring the Transaction as they did—not the anticipated administrative approval by the SEC or any new rule with respect to federal securities issues. Every day that passes the injury continues, as courts "recognize the irreversible harm" that has occurred simply "by

permitting a stockholder vote on a merger to proceed without all material information necessary to make an informed decision." *In re Mony Group Inc. Shareholder Litig.*, 852 A.2d 9, 32 (Del. Ch. 2004) (quotation omitted); *see also id.* ("the irreversible nature of a stockholder vote on a merger supports the argument that any possible harm caused by a tainted voting process would be irreparable").[17]

The Second Circuit has elaborated upon the well-known ripeness standards as to the fitness of the issues and the hardship to the plaintiffs, *see Abbott Lab. v. Gardner*, 387 U.S. 136, 149 (1967), into an examination of five factors. *See Able v. United States*, 88 F.3d 1280, 1290 (2d Cir. 1996) (issues of gays in the armed forces found ripe even before military service action); *see also Burt v. Rumsfeld*, 322 F. Supp. 2d 189, 201 (D. Conn.

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[17] The number of cases recognizing the irreparable harm of permitting or effectuating a shareholder vote without sufficient material information is numerous. *See, e.g., ODS Techs., L.P. v. Marshall*, 832 A.2d 1254, 1263-64 (Del. Ch. 2003) (granting preliminary injunction because the proxy statement was false and misleading. "The threat of an uniformed stockholder vote constitutes irreparable harm. 'It is appropriate for the court to address material disclosure problems through the issuance of a preliminary injunction that persists until the problems are corrected.'") (quoting *In re Staples, Inc. S'holders Litig.*, 792 A.2d 934, 960 (Del. Ch. 2001)); *In re Pure Resources, Inc. Shareholders Litig.*, 808 A.2d 421, 452 (Del. Ch. 2002) ("This court has recognized that irreparable injury is threatened when a stockholder might make a tender or voting decision on the basis of materially misleading or inadequate information); *T. Rowe Price Recovery Fund, L.P. v. Rubin*, 770 A.2d 536, 556 (Del. Ch. 2000) (enjoining execution of agreements because the threatened diversion of company time, attention, assets, and dilution in management constitute irreparable injury); *Sonet v. Plum Creek Timber Co.*, 1999 Del. Ch. LEXIS 49, at * 25 (Del. Ch. Mar. 18, 1999) (" Where a party is found to have disseminated materially misleading information to stockholders (or in this case, Unitholders), preliminary injunctive relief requiring curative disclosure may be awarded."); *Gilmartin v. Adobe Resources Corp.*, 1992 Del. Ch. LEXIS 80, at *43 (Del. Ch. May 6, 1992) ("The Court further concludes that because this information was material to an informed vote by the Preferred Stockholders, those stockholders will be irreparably harmed if the consummation of the merger is not preliminarily enjoined. The right to cast an informed vote is specific, and its proper vindication in this case requires a specific remedy such as an injunction, rather than a substitutionary remedy such as damages. To allow the merger to go forward would deprive the Preferred Stockholders of that right, whereas a preliminary injunction for a brief period to enable the defendants to make corrective disclosure is the remedy most likely to vindicate that right."); *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1062 (Del. Ch. 1987) ("An injunction is the remedy most likely to achieve disclosure of the information necessary to achieve an informed decision"); *Sealy Mattress Co. of N.J. v. Sealy, Inc.*, 532 A.2d 1324, 1340-41 (Del.Ch. 1987) ("Plaintiffs have not received sufficient information to make an informed decision among the available alternatives.... In this case the inability to make that choice constitutes irreparable harm."); *Joseph v. Shell Oil Co.*, 482 A.2d 335, 344 (Del. Ch. 1984) (granting preliminary injunction and ordering the redoing of a fairness opinion for failing to disclose material facts); *American Pacific Corporation v. Super Food Serv., Inc.*, 1982 Del. Ch. LEXIS 551 (Del. Ch. Dec. 6, 1982) (same).

2004) (issue of military recruitment on campus found ripe even before action against schools) (discussing four Second Circuit opinions on ripeness, including *Able*).[18]

Applied here, the Second Circuit factors strongly support a finding of ripeness, at least insofar as the NASD's defective Proxy Statement is a historical fact with a historical outcome, as well as injury that has already been sustained. The facts of this case, and the fitness of the issues for review, concern past violations of Delaware law by the proxy solicitation and vote already held January 19 this year. That proxy solicitation and vote—not SEC action—are at issue; there was nothing hypothetical about those, which were final in their purportedly obtaining valid member approval represented by the NASD to the SEC in partial justification for the Commission's approval of the regulatory consolidation; and those issues are concrete and fit for review. *See Able*, 88 F.3d at 1290; *Burt*, 322 F. Supp.2d at 189 (factors 1, 4 and 5). That member vote approval based upon a deceptive Proxy Statement, as alleged, has already adversely affected class members' voting rights and the value of NASD membership (all as pleaded in the Amended Complaint).[19] Moreover, there is no reason to doubt that final consummation of the matter is imminent.

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[18] *See also Desiderio v. NASD*, 191 F.3d 198, 202 (2d Cir. 1999) (finding suit ripe despite NASD's arguments that further administrative steps were necessary); *SR Intern. Business Ins. Co. v. World Trade Center Properties, LLC*, 2005 U.S. Dist. LEXIS 13001, *2-3 (S.D.N.Y. Feb. 16, 2005) (suit about recovery of 9/11 losses deemed ripe even though "it is subject to future contingencies").

[19] "It must be remembered that [one] is free to litigate proxy-solicitation questions judicially, with or without prior administrative resort to the staff or the [SEC]." *Kixmiller v. SEC*, 492 F.2d 641, 645-46 (D.C. Cir. 1974). The SEC lacks any authority to require a new Proxy or, under its jurisdiction, supervise a new vote based upon full and fair disclosure of all material facts in a new proxy. *See, e.g.*, 17 C.F.R. § 240.14a-9 ("False or misleading statements... (b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the [SEC] shall not be deemed a finding by the [SEC] that such material is accurate or complete or not false or misleading, or that the [SEC] has passed upon the merits of or approved any statement contained therein .... No representation contrary to the foregoing shall be made.")

Id. (factor 2).[20] In fact, the NASD has already announced the leadership structure of the New SRO. *See* Ex. 4.

For all Defendants' talk of contingencies, they do not even attempt to assert, much less actually show, that SEC approval of the consolidation is doubtful or other than imminent. The rest of the world understands it thusly. From how the NASD strategically withheld from the Court what it knew about the closing date of the Transaction, Defendants' silence about any reason to doubt imminent approval can hardly be presumed to hold back something in their favor. To the contrary, if the NASD and the NYSE, having been in constant communication with the SEC throughout this process, have nothing concrete to say to cast doubt on an imminent approval and closing, then vague talk by them about "contingency" can carry little or no credit. "[A] litigant seeking shelter behind a ripeness defense must demonstrate more than a theoretical possibility that harm may be averted." *Public Serv. Co. of N.H. v. Patch*, 962 F. Supp. 222 (D.N.H. 1997) (quoting *Riva v. Massachusetts*, 61 F.3d 1003, 1011 (1st Cir. 1995) (ripeness of challenge to utility restructuring prior to administrative decision on rehearing).

It does not appear that Defendants' single-page challenges to ripeness cite even a single case about unripeness being found with respect to a similar near-consummation merger matter or other extraordinary transaction, or a similar already voted-upon faulty proxy-solicitation, within the Second Circuit—or, for that matter, anywhere else. Defendants' reticence owes not to the absence of cases, but rather to how consistently such

[20] As for factor 3 (*id.* at 201), adjudication will not impede administrative enforcement, for adjudication concerns Delaware law, not federal securities law enforced by the SEC. This is not a suit against the SEC (or any other agency) to block its enforcement, and so factor 3 is not involved. Parenthetically, if defendants want a valid consolidation transaction, and even if the SEC has a benign view of consolidation as a matter of federal securities law, the sooner an adjudication tells Defendants what in the Proxy Statement violated Delaware law, the better for them.

cases have found ripeness. In *Square D Co. v. Schneider S.A.*, 760 F. Supp. 362 (S.D.N.Y. 1991), for instance, the target of a hostile takeover brought suit against the tender offeror on antitrust grounds. Defendants' motion to dismiss argued that the "claim is not ripe. . . its nominees may not be elected." *Id.* at 368. "For purposes of this motion [to dismiss] we reject defendants view. Defendant has announced its intention to engage in a proxy fight . . . . As such, it cannot rely on its possible failure in this endeavor as an excuse to avoid judicial review." *Id.*; *see also Fields v. Coe Mfg. Co.*, 2004 U.S. Dist. LEXIS 10095 (D. Or. May 25, 2004) (misrepresentations alleged in connection with stock purchase agreement; counterclaim challenged as unripe because of "future contingency" but ripeness found anyway). This case is ripe for adjudication by this Court.

Plaintiff does not challenge or seek to reverse an administrative decision or review an order of the SEC, but rather to enjoin the effectuation of a private corporate decision taken based upon an uninformed and defective vote of the membership because the NASD and its Board failed to comply with applicable Delaware statutory and common law and issued a deceptive Proxy Statement in order to obtain member approval.

IV. DEFENDANTS ARE NOT ENTITLED TO ABSOLUTE IMMUNITY WITH RESPECT TO PLAINTIFF'S CLAIMS FOR DAMAGES.

Defendants have only asserted a defense of immunity against Plaintiff's damage claims. They did not assert this defense against Plaintiff's injunction claims.[21] NASD Br.

[21] There would be no basis to do so. Immunity does not bar claims for injunctive relief. *See, e.g., Shmueli v. City of New York*, 424 F.3d 231, 239 (2d Cir. 2005) ("entitlement to absolute immunity from a claim for damages ... does not bar the granting of injunctive relief") (reversing dismissal of equitable relief claims); *see also Youngstown Sheet & Tube Co. v. Sawyer*, 343 U.S. 579, 587 (1952) (Executive Branch officials may be enjoined "whenever their conduct is unauthorized by statute" or exceeds scope of authority); *Heimbach v. Village of Lyons*, 597 F.2d 344, 347 (2d Cir. 1979).

at 15-16; NYSE Br. at 17. Thus, this defense is inapplicable to the issues of the preliminary injunction hearing and may be delayed until after that hearing.

Even as to the damages claims, the Supreme Court allows immunity to be invoked sparingly and only when justified by overriding public policy considerations. Those "seeking absolute immunity bear[] the burden of showing that such immunity is justified for the function in question," and that it is not extended "any further than its justification would warrant." *Burns v. Reed*, 500 U.S. 478, 486-87 (1991). Defendants cannot meet the required burden here. NASD, NYSE as well as other SROs have been sued for damages many times for their actions. Many of these cases, like this case, involved members challenging SRO consolidations or change of control transactions.[22]

Defendants' claim of immunity is premised on the misguided notion that all conduct incident to their delegated regulatory functions, no matter how remotely related to congressionally delegated regulatory activities, is shielded from liability.[23] *See* NASD Br. at 16-19; NYSE Br. at 17-18. The Supreme Court, however, has expressly repudiated Defendants' argument and rejected the notion that immunity attaches whenever "conduct

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[22] *See, e.g., Wey, Hyman, Ginsburg, In re NYSE/Archipelago Merger Litig., Higgins.* No immunity defense was even raised in these cases; the litigation proceeds directly on the merits. *See also Grasso*, 350 F. Supp.2d at 505 & n.6; *Moore v. NASD.*, 1981 U.S. Dist. LEXIS 16774 (D.D.C. Aug. 31, 1981); *Bove v. PBW Stock Exchange, Inc.*, 382 So. 2d 450, 453 (Fla. Ct. App. 1980).

[23] NASD's representations to the Court run counter to positions it has taken in prior litigation. In *NASD v. SEC*, 431 F.3d 803 (D.C. Cir. 2005), for example, to make an argument for standing, NASD made a series of statements contending it is "neither an agency or a state actor." *NASD v. SEC*, Reply Brief of NASD at Page 10, Docket No. 04-1154 (D.C. Cir. 2005). The NASD's brief specifically argued in pertinent part:

> NASD, as a private membership organization, makes numerous admission, retention, and rejection decisions about membership every day. It cannot be the case that each of those decisions, reached by NASD without consultation with the SEC, 'takes on the quality of government action' (SEC's Br. At 22) such that the government may fairly be charged with responsibility for those decisions.

NASD made the same type of argument in *Graman v. NASD*, 1998 U.S. Dist. LEXIS 11624 (D.D.C. 1998), in successfully defeating a claim under 42 U.S.C. § 1983. *See id.* at *3-4.

falls within the scope of ... official duties" stating that "[n]either the purposes of the doctrine of official immunity nor our cases support such a broad view of the scope of absolute immunity." *Westfall v. Erwin*, 484 U.S. 292, 296 (1988).[24]

Immunity in any given case depends on the nature of the function giving rise to a plaintiff's claim. Only when an SRO carries out enforcement activities that the government (*i.e.*, the SEC) would otherwise perform is it immune from suit. This means that only when the SRO is closely regulating market participants or market transactions, as opposed to matters of corporate governance or private transaction, is the SRO immune.

This limitation is well-illustrated in the case law. For instance, in a closely analogous context to Plaintiff's case where immunity was asserted, a court within this district rejected the argument. In *Grasso*, New York brought claims against the NYSE for violating the state's Not-for-Profit Corporation Law by paying Grasso an unreasonable compensation, and because Grasso's compensation was the product of a process infected with conflicts of interest and misrepresentations (in that the Board that approved the compensation package was provided with inaccurate information). There, just as here, the defendants argued the claims were challenging rules "promulgated pursuant to the Exchange Act." *Id.* at 504. This Court (Lynch, J.) rejected these arguments, explaining: "This argument is without merit. The AG is not suing Grasso and the NYSE for 'violation of [the NYSE's] own rules and procedures,' ... nor does federal law give content to the fiduciary duties alleged. The breach of fiduciary duty alleged is entirely predicated on

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[24] *Doe v. McMillan*, 412 U.S. 306, 322 (1973) ("[I]f official immunity automatically attaches to any conduct expressly or impliedly authorized by law, the Court of Appeals correctly dismissed the complaint against these officials. ***This, however, is not the governing rule.***") (emphasis added); *see also Butz v. Economou*, 438 U.S. 478, 510-13 (1978) (rejecting blanket immunity for everyone in Department of Agriculture carrying out government function); *OKC Corp. v. Williams*, 461 F. Supp. 540, 547 (N.D. Tex. 1978) (recognizing no immunity for SEC officials for investigatory function).

state law." *Id.* Furthermore, the Court failed to find any nexus between federal laws or interests under the Exchange Act or SEC regulations and the organizational structure of the NYSE, noting that federal law "leaves the NYSE to organize its governance in accordance with state law." *Id.*

Like *Grasso*, Plaintiff's claims arise under Delaware (or New York) state law and Plaintiff seeks to compel Defendants' compliance with applicable Delaware corporate, common law and statutory mandates.[25] No claim asserts a violation of an SRO rule or federal regulation. Nor is Plaintiff challenging any power specifically delegated to the NASD by Congress under the Exchange Act. Absent any federal law that "*expressly* requires certain responsibilities of directors with respect to stockholders," Defendants cannot possibly be said to be stepping into the shoes of the SEC in a way that might entitle one of them to immunity. *Santa Fe Industries*, 430 U.S. at 479. Under these facts, "state law will govern the internal affairs of the corporation." *Id.*

Not one of the cases Defendants cite undermines this analysis. Not one involved a private function that Congress did not delegate to the SEC under the Exchange Act. Rather, each concerned litigation about an Exchanges congressionally delegated ***regulatory function*** (*i.e.*, fulfilled its policy-making or governmental enforcement role) and involved a market participant or market transaction or issuer. For example, *DL Capital Group, LLC v. Nasdaq*, 409 F.3d 93 (2d Cir. 2005), involved a challenge to Nasdaq's decision to stop trading and cancel trades under its enforcement authority and the reporting of its actions. *Sparta*, 159 F.3d 1209 (9th Cir. 1998), concerned a decision to de-list and suspend trading.

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[25] *Sparta Surgical Corp. v. NASD*, 159 F.3d 1209, 1214 (9th Cir. 1998) ("When conducting private business, [Exchanges] remain subject to liability."); *In re NYSE Specialists Sec. Litig.*, 405 F. Supp. 2d 281, 304 n.7 (S.D.N.Y. 2005) (promotional statements made by the NYSE are not protected by the NYSE's immunity for quasi-governmental functions).

Barbara v. NYSE, 99 F.3d 49 (2d Cir. 1996), like *Austin*, concerned member disciplinary proceedings. *P'Ship Exch. Sec. Co. v. NASD*, 169 F.3d 606 (9th Cir. 1999), also involved disciplinary proceedings. *D'Alessio v. NYSE*, 258 F.3d 93 (2d Cir. 2001), involved a frontal assault on NYSE's actual interpretation, application and enforcement of §11. While *Dexter v. Depository Trust & Clearing Corp.*, 406 F. Supp.2d 260, 262-64 (S.D.N.Y. 2005), concerned regulatory authority of NASD to set an ex-dividend date for a bankrupt company's securities, that was a function that the SEC specifically had delegated.[26] Moreover, courts have recognized that immunity should not be extended derivatively to include those that assist or conspire with immune officials. *See, e.g., Austin*, 757 F.2d. at 693.[27]

In contrast, and as a matter of empirical weight, in a number of similar cases recently brought by SRO members against SROs (including NYSE) and alleging fiduciary violations arising from private corporate mergers or change of control transactions, the SROs (including NYSE) were not immune, and, in many, they did not even bother to assert immunity as a defense. *E.g., Higgins*; *Wey*; *Hyman*; *Ginsburg*; *In re NYSE/Archipelago Merger Litig.* There is no merit to Defendants' immunity defense.

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[26] These cases also identified instances where NASD officials are not immune. *See, e.g., Austin Municipal Securities, Inc. v. NASD*, 757 F.2d 676, 691-92 (5th Cir. 1985) ("The NASD performs myriads of activities in which it and its officers play no adjudicatory role. These include general administrative functions and the operation of the NASDAQ automated quotations system used in the over-the-counter securities market. Defendants lack immunity for these activities."); *Id.* at 692-93 (NASD staff members were not immune and the NASD "concede[d] that Walker and Benton do not have absolute immunity for their roles in the investigation of Austin and as administrators"); *see also Zandford v. NASD*, 80 F.3d 559 (D.C. Cir. 1996) (Table) ("While the NASD and DBCC disciplinary officers are entitled to absolute immunity for actions that are prosecutorial or adjudicative in nature... absolute immunity does not extend to acts that are purely investigatory or administrative.").

[27] Here, as between NYSE and NASD, only NASD is arguably engaged in rulemaking. Under Defendants' analysis then only the NASD is acting pursuant to its regulatory authority. In contrast, as a knowing conspirator in assisting NASD to breach its duties to plaintiff and the Class, the NYSE is not immune.

The SEC is empowered to ensure compliance with the Exchange Act through process and disclosure requirements concerning market participants, issuers, and transactions, not regulate corporate governance. *See, e.g.*, Norman S. Poser, BROKER-DEALER LAW & REGULATION § 13.04 (2d ed. 2001). To clarify the SRO's role in regulation, the 1975 amendments made plain that Exchanges' federal authority is limited to the "power to expel, fine, bar from associating with members, and otherwise sanction its members and persons associated with its members"—the authority "central to the concept of self-regulation, whereby the members of an association regulate *themselves*, subject to government oversight." *Business Roundtable*, 905 F.2d at 414 (emphasis in original). Congress specifically excluded matters unrelated to the purposes of the Exchange Act and "the administration of the exchange." *Id.* (quoting legislative history); §78f(b)(5). Although SROs are required to submit proposed rules to the SEC for approval, the SEC does not, as *Merrill Lynch* explained, have authority over all rules submitted. Congress expressly exempted the internal corporate affairs of Exchanges from SEC purview as these matters are not related to the purpose of the Exchange Act, *see Santa Fe*, leaving states to charter and regulate the corporations they charter. "Such rules did not exercise federal regulatory power, and thus could not preempt state law." *Business Roundtable*, 905 F.2d at 415. "Congress intended to subject the exchanges to state regulation...." *Merrill Lynch*, 414 U.S. at 137. The internal corporate affairs of the exchange fall outside even "the shadow of the federal umbrella" and "is, instead, subject to applicable state law." *Id.* at 130-31.

Regulation of the NASD's corporate governance, By-Law amendments and corporate transactions, including the governance of duties owed by Board member when

communicating with members and seeking approval of a corporate transaction, all are outside the federal umbrella. And, "except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation." *Santa Fe Industries*, 430 U.S. at 479; *Business Roundtable*, 905 F.2d at 413 (SEC lacks authority to "invade[] the 'firmly established' state jurisdiction over corporate governance and shareholder voting rights;" to permit it "would circumvent the legislative process"). *See generally* 4 Louis Loss & Joel Seligman, SECURITIES REGULATION 2007 (3d ed. 1989) ("If Congress had intended to give the Commission power to re-allocate functions between [shareholders or members and directors], so radical a federal intervention would presumably have been more clearly expressed.") The conduct Plaintiff challenges—private, corporate transaction and director shareholder dealings—is beyond SEC scrutiny.

Defendants fail to identify a regulation or statute that expressly requires or prescribes the conduct that Plaintiff challenges. NASD posits that Plaintiff's claims challenge its "rulemaking authority" by seeking damages for the process employed to obtain member approval to amend the By-Laws. *See* NASD Br. at 17. NASD cites §78c(27), §78s(b), and §78o-3(b)(3)-(14) for authority and its contention that By-Laws have the "force of federal law." *Id.*

These provisions fail to corroborate NASD's contention. First, the Second Circuit precedent holds Exchange By-Laws are not "federal law." *Barbara*, 99 F.3d at 55. Second, NASD mischaracterizes the cited sections. For instance, 15 U.S.C. §78c(27) does not "expressly provide[] that the NASD By-Laws are part of [the SEC's] rulemaking

power." NASD Br. at 17. Instead, §78c(27) is the definition provision for "rules of an exchange." Again, *Barbara* holds that such rules are not "federal law."[28]

Third, contrary to NASD's statement, management seeking owner approval of a transaction or by-law amendment is not the exercise of congressionally delegated authority—Congress did not intend the Act to federalize corporate law. *See Santa Fe Industries*, 430 U.S. at 479. Moreover, support cannot be found in 15 U.S.C. §78s(b) either. That section simply requires SRO's to submit all proposed rule changes to the SEC for approval. However, the fact that proposed rules must be submitted to the SEC for approval and checked for compliance with the Exchange Act does not entail that all SRO proposed rules are exercises of congressionally delegated authority. *See Merrill Lynch*; *Business Roundtable*, 905 F.2d at 410-12.[29]

To give effect to Defendants' interpretation requires the Court to disregard the decisions in *Merrill Lynch*, *Santa Fe*, *CTS Corp.*, *Business Roundtable* (and many others) that have all held Congress did not intend for the Exchange Act to regulate the internal affairs of corporations; Congress expressly disclaimed that intent. As Justice Scalia forcefully stated in *CTS Corp.*: "Prescribing voting rights for the governance of state-chartered companies is a traditional state function with which the Federal Congress has ***never ... intentionally interfered.***" 481 U.S. at 96 (emphasis added). "[A]bsent a clear

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[28] *See also* 15 U.S.C. §78s(c)(4)(C) (explaining that amendments to SRO rules that are SEC mandated or undertaken by the SEC remain rules of the SRO and do not become SEC rules); 15 U.S.C. §78s(b)(3)(C) (Exchange may enforce its rule "***to the extent it is not inconsistent with*** the provisions of this title, the rules and regulations thereunder, and applicable Federal and ***State law***.") (emphasis added).

[29] Defendants go outside the record to cite certain comments to the SEC - the vast majority of which speak against the Transaction. However, these comments are irrelevant to this action because the SEC has not asked for comments pertaining to the truth of the Proxy Statements. *See* 72 Fed. Reg. 14149, 14160 (March 26, 2007). Indeed, some of these comments refer to this litigation as a potential source of recourse for NASD members.

indication of congressional intent"—which the Supreme Court held was not included in the 1975 amendments—the SEC lacks authority to federalize state corporate law. 430 U.S. at 479. Plaintiff's claims concern purely private (non-regulatory) conduct; immunity cannot be had.[30]

V. THE AMENDED COMPLAINT STATES CLAIMS UPON WHICH RELIEF MAY BE GRANTED

Plaintiff's claims are as follows: Count I alleges Defendants breached their duties of loyalty, honesty, and candor by their issuance and dissemination of the Proxy Statement. Counts II and III allege Defendants negligently misrepresented in and omitted from matters in the Proxy Statement, and unjustly enriched themselves. Counts V and VI allege that Defendants will have unlawfully converted the NASD Members' Equity and have already diminished the value of NASD membership. And, Counts IV and VII allege that the Defendants substantially diluted the voting rights of the Class and violated the DGCL in failing to hold an annual meeting of NASD members within the prescribed time limits and failing to put the actual terms and conditions of the Transaction to a member vote. Each count states a claim for relief.[31]

A. Plaintiff States a Claim For Breach of Fiduciary Duties.

1. Plaintiff has pleaded the NASD Defendants' fiduciary status.

The SEC has acknowledged that NASD's and NYSE's "directors have fiduciary obligations under state law," 69 FED. REG. 71126, 71141 (Dec. 8, 2004), and SRO's have

[30] Defendants were not delegated lawmaking power. "The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is 'the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.'" *Ernst & Ernst v. Huchfelder*, 425 U.S. 185, 213-14 (1976).

[31] If the Court were to conclude that any of counts in the Amended Complaint fall short as a result of any omissions, technical pleading defects, or the like—which it should not do—the Court should dismiss them without prejudice and allow Plaintiff an opportunity to re-plead them.

been subject to numerous breach of fiduciary suits under state law. *See, e.g.*, *Wey*, Slip Op. at 15-18; *Hyman*, 2007 NY Misc. LEXIS 143, at *8 (Sup. Ct., NY County, Jan. 10, 2007); *Ginsburg; Higgins*, 806 N.Y.S.2d 339 at 347; *In re NYSE/Archipelago Merger Litig.*, 2005 N.Y. Misc. LEXIS 3184, at *6-7; *see also Bove*, 382 So. 2d at 453 (Fla. Ct. App. 1980) ("officers and directors stand in a fiduciary relationship to the shareholders (members) and are bound to exercise the highest degree of fidelity and fairness in all their dealings with them").

Yet the NASD Defendants lead off with the argument that Plaintiff's fiduciary claims—and, in particular, Plaintiff's claims that arise from the Proxy Statement—fail on the ground that NASD owed its members no fiduciary duty because NASD is a not-for-profit organization that must act in the public interest rather than serve the interests of its members. *See* NASD Br. at 20-21. Imposing fiduciary duties, they claim, would be incompatible with NASD's "unique regulatory role and not-for-profit status." *Id.* at 21.

The Court should not even address Defendants' arguments at this stage. Plaintiff has exceeded its notice pleading obligations by alleging that the relevant Defendants acted as fiduciaries in the context of the Transaction. *See, e.g.*, Amended Complaint ¶ 60. Fiduciary status raises complex issues of fact, in addition to law, whose resolution should generally await the development of an evidentiary record. They should not usually be decided at the summary-judgment stage, let alone the motion-to-dismiss stage. *See, e.g.*, *Toussaint v. JJ Weiser & Co.*, 2005 U.S. Dist. LEXIS 2133, *23-24 (S.D.N.Y. Feb. 13, 2005); *Liss* v. *Smith*, 991 F. Supp. 278, 304 (S.D.N.Y. 1998). It is significant that, in arguing against fiduciary status, the NASD Defendants do not confine themselves to the pleadings, but instead rely on documents outside the Amended Complaint, *see* NYSD Br.

at 21 & n.9, and critical factual statements that flatly contradict to their own documents—among them the statement that "NASD Members have no claim to NASD assets." *Id.* at 21. *Contra* Ex. 1 (NASD annual report specifically referring to "Members' Equity").

The NASD Defendants contend here that they were not fiduciaries because the NASD often stands in an adversarial relationship with its members with respect to disciplinary and related matters. *See* NASD Br. at 20. But fiduciary status is not an all or nothing proposition. A person can be—and often is—a fiduciary with respect to one action but not another. *See, e.g.*, *In re Marsh ERISA Litig.*, 2006 U.S. Dist. LEXIS 90631, *15-16 (S.D.N.Y. Dec. 14, 2006); *In re Polaroid ERISA Litig.*, 362 F. Supp. 2d 461, 472 (S.D.N.Y. 2005). Plaintiff does not contend, contrary to Defendants' suggestion, that the NASD members acted in a fiduciary capacity in all their dealings with NASD members. Plaintiffs contend only that the NASD Defendants acted as fiduciaries with respect to the particular actions challenged in the Amended Complaint's fiduciary duty counts. Chief among those challenged actions was the dissemination of a deceptive Proxy Statement that misrepresented and failed to disclose critical aspects of the Transaction, none of them more important in this case than the treatment of what the NASD itself calls "Members' Equity."

As to those matters at least, the NASD owe and owed fiduciaries duties to NASD members. The NASD is not, as Defendants' contend, a "typical for-profit corporation," NASD Br. at 20, but as the Amended Complaint alleges and the NASD's own documents establish, the NASD does hold $1.6 billion in assets that belong to its members—again, what the NASD itself calls "Members' Equity." That critical fact alone establishes a fiduciary relationship between the NASD Defendants and the NASD members.

It is simply not true, as the NASD Defendants contend, that a fiduciary obligation would exist under the circumstances of this case only if the NASD were a for-profit corporation in which the NASD members were owner-shareholders. Numerous contrary examples abound that prove the NASD Defendants wrong. One prominent example arises in the context of an insurance company's conversion from mutual to stock form. A number of courts have concluded that although an insurance company owes a policyholder no fiduciary duty with respect to the disposition of claims and related matters, it does owe policyholders a fiduciary duty with respect to the treatment of their equity in the company when it converts to for-profit status. The courts have reached this conclusion even though the policyholders' equity or ownership interest, like the NASD Members' Equity here, does not take the form of stock ownership. *See, e.g., Reiff v. Evans*, 630 N.W.2d 278, 291 (Iowa 2001); *Heritage Healthcare Serv., Inc v. The Becon Mutual Ins. Co.*, 2004 R.I. Super. LEXIS 29, *11-13 (R.I. Sup. Ct. Jan. 21, 2004); *Silverman v. Liberty Mut. Ins. Co.*, 13 Mass L. Rep. 303, 2001 Mass. Super. LEXIS 255, *17020 (Mass. Sup. Ct. July 11, 2001).

2. Defendants breached their duties of loyalty, honesty, and candor in issuing and disseminating the Proxy Statement

Defendants contend for one reason or another that, contrary to Plaintiff's allegations, the proxy statement passes muster under Delaware law. The adequacy of a proxy statement, however, should not generally be decided on a motion-to-dismiss. *See, e.g., Block Fin. Corp. v. Inisofi Corp.*, 2006 Del. Super. LEXIS 451, at *9-10 (Del. Sup. Oct.30, 2006) (noting materiality of omissions and misrepresentation are issues of fact and inappropriate for summary judgment). It should be decided against the background of a

full factual record developed after the parties have had an opportunity for discovery. In any event, it is clear here that none of Defendants' arguments has any merit.

Delaware imposes upon the NASD and the individual Defendants a duty to disclose fully and fairly all material facts within their control that would effect a member's deliberations. *See, e.g., Stroud v. Grace*, 606 A.2d 75 (Del. 1992); *Malone*, 722 A.2d at 9; *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985); *Oliver v. Boston University*, 2006 Del. Ch. Lexis 75, at *135 (Del. Ch. April 14, 2006). The key inquiry is the materiality of the omission or misstatement. *See, e.g., Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 143 (Del. 1997); *Boston University*, 2006 Del. Ch. Lexis 75, at *135.[32]

A fact is material in the context of the Proxy Statement

> if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Rosenblatt, 493 A.2d at 944 (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)); *Mony Group*, 852 A.2d 9 (Del. Ch. 2004). This "materiality standard is an objective one, measured from the point of view of [a] reasonable investor[] [and not] the

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[32] It is disingenuous for NASD to suggest that a full and complete history of the events and negotiations is not required because NASD Members were not being asked to vote on the Transaction. NASD Br. at 23 n.10. The Proxy Statement included the partial history and thus evidences the materiality of the full and complete history. Furthermore, under *Arnold*, the disclosure of a nonmaterial fact can "trigger an obligation to disclose additional, otherwise non-material facts in order to prevent the initial disclosure from materially misleading the stockholders." *Virn v. VLI, Corp.*, 681 A.2d 1050, 1056 (Del. 1996). Lastly, if NASD is correct and there is no duty to disclose the history of the Transaction or "reasons for the consolidation"—a position plaintiff doubts highly—then its existing partial disclosures are "unnecessary and, therefore, misleading." *Eisenberg*, 537 A.2d at 1062.

subjective views of the directors," *Zirn v. VLI Corp.*, 621 A.2d 773, 779 (Del. 1993),[33] and requires disclosure, in neutral, non-pejorative terms, all material facts bearing upon the issue upon which a vote is being sought.

The disclosure duties are augmented further by the rule that once a disclosure is made that information must not be misleading. *Mony Group*, 852 A.2d at 25; *Staples*, 792 A.2d at 954. In other words, although "Delaware law does not require disclosure of inherently unreliable or speculative information which would tend to confuse stockholders or inundate them with an overload of information," once a company "travel[s] down the road of partial disclosure of the history leading up to the [Transaction] . . . [it has] an obligation to provide the stockholders with an accurate, full, and fair characterization of those historic events." *Arnold v. Soc'y for Say. Bankcorp.*, 650 A.2d 1270, 1280 (Del. 1994); *Lynch v. Vickers Energy Corp.*, 383 A.2d 278, 281 (Del. 1978); *Mony Group*, 852 A.2d at 27; *see also Freedman v. Restaurant Assoc. Indust., Inc.*, 1990 Del. Ch. LEXIS 142, at *15, *24 (Del. Ch. Sept. 19, 1990) (In a proxy, "where management chooses to disclose its motives or the purposes of a transaction, it has an obligation to disclose those purposes honestly and candidly.").

The deceptions alleged by Plaintiff and statements identified above lie at the heart of a member's determination to vote "yes" on the deal. The carrot is clearly the financial incentives.

REDACTED

[33] Corporate fiduciaries "are not required to confess wrongdoing or engage in self-flagellation in proxy materials." *Citron v. E.I. du Pont de Nemours & Co.*, 584 A.2d 490, 503 (Del. Ch. 1990). "Self-flagellation," as that term is used, involves the drawing of "legal conclusions implicating [the board] in a breach of fiduciary duty from surrounding facts and circumstances prior to a formal adjudication of the matter." *Mony Group*, 852 A.2d at 25.

REDACTED The source of the cash is also material because the Proxy Statement does not really disclose that the financial incentives being offered to NASD members to obtain their "yes" votes comes from Members' Equity. The stick is of course the threat of SEC intervention. Once used as a threat, the facts and circumstance surrounding it must be fully disclosed.

Disclosure of the background of the Transaction is similarly material. Plaintiff understands, under these ordinary duties, disclosure does not require a "blow-by-blow" description of events leading up to the Transaction or the disclosure of "all available information," *Stroud*, 606 A.2d at 75, but the Proxy Statement must disclose all material information necessary to make disclosure of their recommendation accurate and complete, particularly in the context of the Transaction as proposed (which, again, virtually deprives NASD members of any governance in the new SRO). *See, e.g., Zirn*, 621 A.2d at 779 (Board must provide "all the information which a reasonable" member "would consider important"); *id.* at 779-80 ("a fiduciary's duty is best discharged through a broad rather than a restrictive approach to disclosure").[34]

But because here it is the NASD that is purchasing the Members' Equity in the NASD, the fiduciary obligations related to disclosure and candor are at their highest and more onerous than ordinary, indeed "exacting." *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1057 (Del. Ch. 1987); *see also Blanchette v. Providence & Worcester Co.*, 428 F. Supp. 347, 356 (D. Del. 1977) ("heavy responsibility of advising the stockholders fully and impartially about the advantages and disadvantages" of their vote); *Plaza*

[34] Additionally, to the extent that any Board member possessed or used superior knowledge to which the members and/or other Board members were not privy, the fiduciary obligation of candor, loyalty and fair dealing is violated. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

Securities Co. v. Fruehauf Corp., 643 F. Supp. 1535, 1544 (E.D. Mich. 1986) ("judicial review of disclosures and nondisclosures must be especially rigorous" in this context where material facts are "exclusively within" the possession of management, whose interests "are in conflict with those of the shareholders"). Additionally, because of the built-in conflict of interest, courts are sensitive to coercive offers, where the offer, by reason of its terms or the circumstances under which it is made, is wrongfully coercive. *Eisenberg*, 537 A.2d at 1056.

Defendants have provided a description of events and reasons for the NASD Board's decision to approve the Transaction. This voluntary disclosure thus triggered Plaintiff's right to receive a full disclosure of all material information and historical events leading up to the Board's approval of the Transaction in its present form and terms. *Id.*; *Rosenblatt*, 493 A.2d at 944; *Arnold*, 650 A.2d at 1280; *Boston University*, 2006 Del. Ch. Lexis 75, at *135; *Mony Group*, 852 A.2d at 25. This includes a candid and full disclosure of why the Transaction is being made and its purpose. *Eisenberg*, 537 A.2d at 1059.[35] Also required is a full and impartial disclosure about the advantages and disadvantages to the members in voting to approve the changes. *See, e.g., Blanchette*, 428 F. Supp. at 356 ("heavy responsibility of advising the stockholders fully and impartially about the advantages and disadvantages" of their vote). The Proxy Statement fails to comply with the law.

Here, as discussed above, the Proxy Statement fails to disclose all of the material facts and circumstances surrounding the Transaction that the Board actually considered in

[35] Defendants' contention that some of the information is obvious and therefore not required to be disclosed is an incorrect statement of the law. While some facts may be obvious, what is not, and what members are entitled to know, is "the role played" by such obvious facts in the Board's deliberations. *Eisenberg*, 537 A.2d at 1060.

its vote, though it purports to identify some of the considerations. Having made the partial disclosure, Defendants were required to make a full disclosure of all material facts bearing on the Transaction, a duty that the Defendants failed to fulfill as is further explained below.

The Board's consideration of expert advice is also critical. Members are entitled to know whether the Board considered any expert advice in making its determination and, if it did, a fair summary of that advice and investigations the advisor(s) undertook *In re Pure Resources, Inc. Shareholders Litig*, 808 A.2d 421, 449 (Del. Ch. 2001). Furthermore, such information is material. *Kahn v. Tremont Corp.*, 694 A.2d 422, 430, 432 (Del. 1997); *Rosenblatt*, 493 A.2d at 944-45. The fairness of any complex transaction that is put to shareholders for approval typically includes a fairness opinion or assistance of experts. *QVC*, 637 A.2d 34, 45 n.14 (Del. 1994); *Smith v. Van Gorken*, 488 A.2d 858, 876-77 (Del. 1985).

Additionally, the Proxy Statement provided the purported reason why the one-time payment of $35,000 could not possibly be increased: "NASD is a tax-exempt organization and therefore is limited by tax laws regarding size and source of payments it can make to its members. The special member payment of $35,000 per NASD member, or approximately $175.0 million in the aggregate, will be funded by—and therefore limited by—the expected value of the incremental cash flows that will be produced by the consolidation transaction." Ex. 2 at 7. Having made this partial explanation, the NASD Defendants were under a duty to explain how it had arrived at this determination, what factors were considered to determine the "expected value of the incremental cash flows that will be produced by the consolidation transaction," and under what advice, if any, the Board sought out or received in making such a declaration. *TSC Industries*, 426 U.S. at

449; *Zirn*, 621 A.2d at 779; *Rosenblatt*, 493 A.2d at 944; *Van Gorken*, 488 A.2d at 876-77; *Matador Capital*, 729 A.2d at 296. Members were entitled to "be informed of information in the fiduciaries' possession that is material to the fairness of the price." *Eisenberg*, 537 A.2d at 1059.[36]

Further, the Proxy Statement is coercive under state law. It is similar to the unlawful coercive disclosure in *Lacos Land Company v. Arden Group, Inc.*, 517 A.2d 271 (Del. Ch. 1986). In *Lacos Land*, the issuance of a new class of "supervoting" preferred stock was enjoined on the ground that a disclosure in the proxy statement soliciting votes in favor of a charter amendment creating a proposed new class of preferred was wrongfully coercive. The offending disclosure consisted of a statement that unless shareholders voted to approve the amendments, the corporation's chief executive officer and largest stockholder would oppose transactions that the directors could determine were in the best interests of all stockholders. Here, there are three disclosures that amount to the same thing. **REDACTED** Next, there is the statement that NYSE will not consolidate unless members give up their control and voting rights. Finally, there is the statement that the SEC will unilaterally come in and change the By-Laws if members do not vote in favor the amendments. *See also Eisenberg*, 537 A.2d at 1062 (Proxy was coercive when it acknowledged possibility of delisting of shares from NYSE if shareholders did not approve).

[36] Having made this representation, the Proxy Statement was also required to disclose the correlative probabilities of the IRS taking no action and include the amounts at which IRS action was unlikely or became highly likely. *See, e.g., Lynch*, 383 A.2d at 280-81 (requiring disclosure of equally trustworthy ceiling value when a floor was disclosed).

Additionally, Delaware law requires the Board to consider alternatives and disclose the alternatives considered. The Transaction involves a change in control of the NASD. In fact, Plaintiff and the Class go from having voting control over all Board Members to each class member having voting control over 3 (or less) of the 23 New SRO Board members. In mathematical terms, at best, that is going from 100% voting control to 13%. Under theses circumstances, NASD is required to show that the process it engaged in was fair and "based on a deliberate and knowledgeable exploration of alternatives." *Matador Capital*, 729 A.2d at 292; *see also QVC*, 637 A.2d at 44-45 (discussing the requirements and how to consider alternatives).

B. The Amended Complaint States a Claim for Negligent Misrepresentation.

For the reasons state above in the Preliminary Statement, the Proxy Statement contains material misrepresentations that support a claim for negligent misrepresentation. Additionally, the real issue is whether the Proxy Statement's misrepresentations and omissions caused absent class members to vote in favor of the amendments. In this respect, reliance can be found if the disclosures are unduly coercive; the intent of the Proxy is to have others rely and deceive them into obtaining vote. *Eisenberg*, 537 A.2d at 1061-62.

Moreover, a complaint states a claim for fraud or misrepresentation on a more lenient standard when, as here, the details of the "who, what, where, and when" are peculiarly within the knowledge of the Defendants. *Bernstein v. Kelso & Co.*,231 A.D.2d 314, 321 (N.Y. App. 1997). Plaintiff should be allowed to take discovery and replead, if warranted, this claim. Lastly, matters of fraud, misrepresentation, materiality and the like

are inherently fact-based determinations and thus not appropriate for resolution on a motion to dismiss.

C. The Amended Complaint States a Claim for Unjust Enrichment.

Plaintiff's unjust enrichment claim is predicated on the individual Defendants' actions and scheme to obtain control of the NASD unjustly at a woefully depressed price results from their self-dealing and control of the NASD's suffrage process.[37] Stated otherwise, the interest of Plaintiff's and class members are at odds with Defendants' interests; in paying members $35,000 (less than the true value of Member's Equity which is $1.6 billion or at least $135,000 per member). *See Higgins*, 2005 N.Y. Misc. LEXIS 1869, at *8-10. Thus, Defendants by, among other things, appropriating for themselves more than $1.5 billion in Members' Equity as well as other benefits.

Contrary to Defendants' arguments, the alleged harm here is direct to Plaintiff and the members of the Class and is not derivative, particularly since Plaintiff has not claimed that NASD has sustained or will sustained any damages as a result of the wrongdoing alleged. NASD Br. at 29. NASD is not injured at all nor are all its members damaged equally. The Class is specifically defined to exclude those members of NASD which are also NYSE members since only the members of the Class have been and will be damaged by what has transpired and will transpire if the Transaction is consummated.

D. The Claims Pleaded in the Amended Complaint Are Direct, Not Derivative.

Plaintiff's claims are direct rather than derivative because Defendants' actions stripped Plaintiff and putative class members of rights belonging to them individually,

[37] "Member's Equity" appears with liabilities on the corporation's balance sheet. *Higgins*, 2005 N.Y. Misc. LEXIS 1869, at *8 n.20. It is not a NASD asset, contrary to NYSE's contention. NYSE Br. at 20-21.

causing these members to suffer an injury independent of any injury suffered by the NASD. Indeed, the Amended Complaint does not allege that NASD sustained or will sustain any damages.

Specifically, in addition to the direct economic damages to Plaintiff and members of the class referred to above, the proposed Transaction would constitute a wrongful change of control over the NASD that transferred and diluted the voting control of Plaintiff and class members (1) in violation of DGCL §255 without submitting the Transaction to a vote of the Members; (2) without payment of a control premium and (3) in breach of duties already discussed.

The Delaware Supreme Court recently articulated the inquiry necessary to determine whether a claim is direct or derivative. In *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004), the Court defined the relevant inquiry as: (1) whether the corporation or the shareholder suffered the alleged harm; and (2) who should receive the benefit of recovery or other remedy. *Id.* at 1033; *see also Gentile v. Rossette*, 906 A.2d 91, 93, 98-99 (Del. 2006). To maintain a direct claim, the shareholder's direct injury "must be independent of any alleged injury to the corporation." *Tooley*, 845 A.2d at 1039. In determining whether the injury is suffered by the company or the shareholder, the fact that all shareholders may suffer the same injury is immaterial and irrelevant. *Id.* at 1037 ("a direct, individual claim of stockholders that does not depend on harm to the corporation can also fall on all stockholders equally, without the claim thereby becoming a derivative claim"); *see also Agostino v. Hicks*, 845 A.2d 1110, 1121 (Del. Ch. 2004) ("In my opinion, what must be discarded is the notion of using special injury, i.e., 'injury [suffered by the particular plaintiff] which is separate and distinct from that suffered by

other shareholders' as a talismanic entreaty to the assertion of an individual claim"). The deciding factor is whether the right enforced exists independent from any right held by the corporation. *See* Donald J. Wolfe, Jr. & Michael A. Pittenger, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY § 9-2[a] (2006). In any event, as noted above, all NASD members are not victims of Defendants' alleged wrongdoing in the same way either. Only class members (*i.e.*, NASD members who are not also NYSE members) are aggrieved by the transfer of their voting control through Defendants' inequitable action because it was the class members (approximately 4,900 of the NASD's 5,100 members) that had control over the Board not those members that were also NYSE members (about 200).[38]

Prior to the proposed Transaction, NASD Members possessed 100% of the NASD members' equity and controlled its direction. Under the terms of the Transaction, the Class has lost their right to assert majority control—a right held by the Class, collectively, not by the NASD. This loss of control directly impacts the class members' voting rights. Delaware courts have long held that the right to assert majority control belongs to shareholders *qua* shareholders and "exists independently of any right of the corporation." *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1070 (Del. Ch. 1985).[39] *Accord In re Gaylord Container Corp.*

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[38] *See, e.g., Lipton v. News International PLC*, 514 A.2d 1075, 1084-85 (Del. 1986) (sale of 19% of corporate stock which changed corporate control over Board constituted a direct and "special injury" to shareholders); *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1189 (Del. Ch. 1998) (adoption of plan tat prohibited shareholders from electing new board in future pled direct injury); *Avacus Partners v. Brian*, 1990 Del. Ch. LEXIS 178, at *23 (Del. Ch. Oct. 24,1990). (change in by-laws can only harm shareholders directly because it involves shareholder right to elect directors).

[39] Even when control of a company is not being transferred, voting power dilution constitutes a direct claim because it directly harms shareholders without affecting the corporation, and any remedy for the harm suffered under those circumstances would benefit the shareholders. *See, e.g., In re J.P. Morgan Chase & Co.*

Shareholders Litig., 747 A.2d 71, 84 (Del. Ch. 1999); *Gentile v. Rossette*, 906 A.2d 91, 98 (Del. 2006) (vote dilution claim is direct).

Nor is there any doubt that Delaware recognizes that the loss of the right to assert voting control occasions a real, direct injury to shareholders. Delaware courts have recognized this concept and allowed shareholders to directly recover money damages for this injury. *See, e.g., QVC*, 637 A.2d 34 (Del. 1994). Any monetary remedy regarding majority voting control dilution would go to the Class individually. Further, any equitable remedy, such as an injunction or rescission resulting in the unwinding of the Transaction, would inure to the benefit of the Class. Therefore, Plaintiff's claims satisfy *Tooley*.

Defendants' argument against Plaintiff's dilution claims completely misses the point. Unlike here, in none of the cases cited by Defendants, was there a change of control. For example, in *Boston University*, 2006 Del. Ch. LEXIS 75, the company was controlled by a majority shareholder before plaintiffs' equity was diluted and thus plaintiffs did not lose corporate control because they never had it. Additionally, in *Oliver* the court expressly found that plaintiffs voting dilution claim was direct. *Id.* at *76. Similarly, in *Gatz v. Ponsoldt*, 2004 Del. Ch. LEXIS 203 (Del. Ch. Nov. 5, 2004), the complaining shareholders never controlled the company.[40] Thus, unlike here, none of the cases cited by Defendants involve a change in control that requires a control premium and

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S'holder Litig., 906 A.2d 808, 2005 Del. Ch. LEXIS 51, * 5-7 (Apr. 29, 2005); *In re Tri-Star Pictures*, 634 A.2d 319, 330 (Del. 1993); *Boston University*, 2006 Del. Ch. LEXIS at *76; *Tse v. Ventana Med.Sys.*, 1998 U.S. Dist. LEXIS 16760, at *47 (D. Del. Sept. 23, 1998).

[40] The court made the same distinction in *Agostino v. Hicks*, 845 A.2d 1110 (Del. Ch. 2004), in holding the claims at issue were derivative. Specifically, the Court held that the "most important" reason the claims asserted were not direct was because "there was no loss of [majority] voting power requiring compensation"—both before and after the transaction plaintiff "did not have majority status" and "was not entitled to a control premium." *Id.* at 1124.

imposition of heightened duties on the Board. Thus, none of the cases relied upon by the Defendants involve the same injury as that alleged in the Amended Complaint.

Here, the Class consists of the NASD Members who are not also NYSE Members. Collectively, they controlled the NASD until the Transaction. The claims regarding dilution are direct, not derivative. There was a change of control. The members of the class lost their right to assert majority voting control or to be compensated for it; a right belonging to the members collectively and not the NASD. Accordingly, any claim to enforce this right or seek compensation for its loss, is properly brought by the Class directly and without the procedural prerequisites necessary when a shareholder sues to enforce a right belonging to a corporation.

E. The Amended Complaint States a Claim Relating to an Election.

Plaintiff acknowledges that DGCL § 211(c) does not apply to the facts here. Nevertheless, Plaintiff still states a claim for holding an election of NASD Board of Governors as DGCL § 215(d) provides:

> If the election of the governing body of any nonstock corporation shall not be held on the day designated by the bylaws, the governing body shall cause the election to be held as soon thereafter as convenient. The failure to hold such an election at the designated time shall not work any forfeiture or dissolution of the corporation, but the Court of Chancery may summarily order such an election to be held upon the application of any member of the corporation.

Under this provision, the Court can still order an election, should the Court deem it warranted under the facts. NASD has not elected new Governors since February 3, 2006. Given that there has not been an Annual Meeting in over 13 months, nor is there one scheduled in the near future (or at all), and given that DGCL § 215(d) empowers the Court to order an election to be held upon the application of any member, Plaintiff states a claim.

F. Plaintiff States a Claim for Failure to Hold a Vote on the Transaction.

In an attempt to spare the Transaction from obligations under Delaware law governing a merger or consolidation, Defendants dispute that the Transaction qualifies as a merger or consolidation. But Defendants' own proxy statement undercuts their position. *See, e.g.*, Proxy Statement at 13; *id.* at 1. In fact, at page 1 the Proxy Statement discloses the existence of a "consolidation plan" as well as explaining that the "consolidation plan" was approved by the Boards and will create a "newly consolidated organization." In addition to Defendants' description in the Proxy Statement of the Transaction as a consolidation on countless occasions, in point of fact the Transaction is the merger or consolidation of two corporations into the New SRO. The NASD will cease to exist upon the creation of the New SRO. The New SRO will combine the members of the NASD and NYSE, possess all the powers, rights, and privileges that the NASD had as well as be "subject to all the restrictions, disabilities and duties" of the NASD; the New SRO will also own all of the NASD's property, real, personal and mixed, and debts; and similarly, all rights of creditors and all liens upon property are preserved unimpaired, become attached to the New SRO. *Cf.* 8 DGCL § 259.

Additionally, unlike its controlling position over the NASD, the Class will not have control over the New SRO. Thus, the New SRO will have new owners.[41] The New SRO will also have a different name, new articles of incorporation, and a vastly different organic structure and corporate existence than the NASD.[42]

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[41] From plaintiff's review of the Proxy it appears defendant Schapiro will be entitled to appoint (or at least participate in appointing) anywhere from 8-11 Board members for the New SRO, and she will also be a Board Member.

[42] Approval of an organic change to corporate entity must comply with Delaware statutory procedure and must be based on full and fair disclosure. *Williams v. Geier*, 671 A.2d 1368, 1379 (Del. 1996).

In sum, Defendants repeatedly called the Transaction a consolidation and disclosed to Plaintiff and the members of the class that it was a consolidation and that the Boards of the two SRO's approved a "consolidation plan"; the Transaction results in a fundamental change in control such that the New SRO has new owners; and the NASD will cease to exist and a new entity will be created, one that combines the functions, assets, and expenses of the two entities into one member regulation entity called New SRO. This is a consolidation.

NASD's argument that the Transaction is not a consolidation is meritless and disingenuous.[43] Moreover, although the Transaction can be seen as an asset purchase, the fact remains that the NASD and NYSE labeled the form of the Transaction as a "consolidation." And it possesses all the attributes of a merger or other form of consolidation. Having described and characterized the Transaction in this form, it is irrelevant that other statutory restraints or criteria might also apply. NASD chose the form of the transaction and described it as such and now must live with the consequences.

Among the requirements that the DGCL imposes on the proposed consolidation that were violated are: (a) the consolidation plan or merger agreement must itself be submitted to the NASD members for approval; and (b) an absolute majority of the members must approve the Transaction before it becomes effective. 8 DGCL § 255. According to the NASD, its voting members were only being asked to vote on the

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[43] Also, a merger and/or consolidation does not require that both companies cease to exist, as NASD contends. *Drug, Inc. v. Hunt*, 168 A. 87, 96 (Del. 1933) (neither corporate entity ceased to exist).

proposed amendments to the By-Laws; neither the proposed consolidation nor its terms were presented to the members for a vote.[44] Ex. 2 at 7.[45]

G. The Amended Complaint States a Claim For Breach of Duty of Care: Because the Transaction Involves a Change of Control, the Board Has Heightened Fiduciary Responsibilities to Its Members.

1. Defendants must show that the Transaction was fair.

The traditional business judgment rule applied under Delaware law is modified in circumstances, such as here, when the change of control of a corporation is at issue heightened fiduciary responsibilities on the part of the board of directors must be examined. *See, e.g.*, *Matador Capital*, 729 A.2d at 290 (citing *QVC*, 637 A.2d at 44); *Mony Group*, 852 A.2d 9 at 19. "In the sale of control context, the directors must focus on one primary objective—to secure the transaction offering the best value reasonably available for the stockholders—and they must exercise their fiduciary duties to further that end." *QVC*, 637 A.2d at 44.

To determine whether NASD satisfied this responsibility, courts apply enhanced scrutiny and examine as a threshold matters that consist of:

> (a) a judicial determination regarding the adequacy of the decisionmaking process employed by the directors, including the information on which the directors based their decision; and
>
> (b) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing. The directors have the burden of proving that they were adequately informed and acted reasonably.

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[44] According to NYSE, the terms of the deal are not yet negotiated or final. NYSE Br. at 23.

[45] Despite defendants' representations to the Court that the amendments to the By-Laws "were approved by a significant majority," the reality is plaintiff does not know whether an absolute majority of NASD Members approved the amendments to the By-Laws because the actual vote was only an approval by a majority of a *quorum* of voting members. *See* NASD SEC Filing at 3. Discovery should clarify this issue.

QVC, 637 A.2d at 45.[46] Thus, NASD has the burden of proving that its Board of Governors were adequately informed and acted reasonably in light of the circumstances.

> Although an enhanced scrutiny test involves a review of the reasonableness of the substantive merits of a board's actions, a court should not ignore the complexity of the directors' task in a sale of control. There are many business and financial considerations implicated .... The board of directors is the corporate decision making body best equipped to make these judgments. Accordingly, a court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.

Matador Capital, 729 A.2d at 290-91 (quotation omitted). In this regard, NASD's Board has a duty of diligence and vigilance, which "require[] a director to take an active and direct role" from beginning to end. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 368 (Del. 1993).

2. The Transaction does not meet the standards for fair dealing under Delaware law.

The inquiry here has two aspects: (1) fair dealing or fair process; and (2) fair price. The fair dealing inquiry "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of

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[46] In assessing the value of an interest where there is no market value, courts attempt to discern the value "taking into consideration the original capital, assets and liabilities, whether there has been a profit or loss, dividends paid, and generally everything that might affect its value." *Tansey v. Trade Show News Networks, Inc.*, 2001 Del. Ch. Lexis 142, *29 n.35 (Ch. Del. Nov. 27, 2001); *see also* RESTATEMENT (SECOND) TORTS § 911 cmt. f. ("In determining the value of corporate shares [in which there is no ready market], the net worth of the corporation may be considered."). That being said, liquidation or sales value should not be used in arriving at asset value because such a valuation is contrary to the main purpose of finding the going concern value of assets to the company whose shares are being appraised. *Levin v. Midland-Ross Corp.*, 194 A.2d 50 (Ch. Del. 1963). In a similar vein, speculative tax liabilities that might be imposed (*e.g.*, because of distribution to members) are also not considered. *Ng v. Heng Sang Realty Corp.*, 2004 Del. Ch. Lexis 69 at *18-19 (Del. Ch. Apr. 22, 2004).

the directors and the stockholders were obtained." *Weinberger*, 457 A.2d at 711. Such a process requires "an active decisionmaking process based on a deliberate and knowledgeable exploration of alternatives." *Matador Capital*, 729 A.2d at 292.

Here, it is notable that the NASD admits that alternatives to the Transaction were not considered at all. Moreover, NASD has not shown any indication that there was an active decisionmaking process based on a deliberate and knowledgeable exploration of alternatives. Clearly there exist various other means by which a consolidation of the regulatory functions of NASD and NYSE, as wished by the SEC, could have been effectuated without emasculating class members' voting rights or providing the gift to NYSE members of the bulk of NASD membership value.

Moreover, as alleged, the terms of the consolidation were negotiated on behalf of NASD by Defendant Mary Schapiro, a prime beneficiary of the Transaction, and were presented to the full Board for its approval without the benefit of adequate documentation. Even still, one NASD Governor opposed the Transaction and one other abstained from voting upon it.

Additionally, because NASD's Board of Governors approved the consolidation and did so while acting under a duty "reasonably to seek the transaction offering the best value reasonably available," *QVC*, 637 A.2d at 44, the Board's recommendation carried with it an implicit representation that their actions comported with this duty. Thus, upon such a recommendation the Board was required to "disclose such information about the background of the transaction, the process followed by them to maximize value, and their reason for approving the transaction so as to be materially accurate and complete." *Matador Capital*, 729 A.2d at 295. The Proxy Statement is devoid of any discussion about

what steps, if any, the Board took to maximize the terms from the perspective of NASD's members.

Because it is the NASD Board—those who have fiduciary obligations to members—that is effectively taking away control of NASD from Plaintiff and the class "the exacting duty of disclosure imposed upon corporate fiduciaries is even 'more onerous' than in a contested offer." *Eisenberg*, 537 A.2d at 1056. It imposes a "heavy responsibility of advising the [members] fully and impartially about the advantages and disadvantages" of the offer. *Blanchette*, 428 F. Supp. at 356. It is "the strictest possible standard of disclosure." Plaintiff and class members were entitled to everything ordinarily required to be disclosed and also required to be informed of all "information ***in the fiduciaries possession*** that is material to the fairness of the price." *Eisenberg*, 537 A.2d at 1059 (emphasis added).

Here, and in this regard, the Proxy Statement fails convincingly for all of the reasons discussed. Again, the Proxy Statement discloses that NASD retained an "independent third-party financial advisor to determine whether the consideration to be paid by NASD in the Transaction is fair" and represented that it is financially fair. The Proxy, however, fails to disclose what advice that person gave, what investigation was undertaken to determine the fairness of the price, whether the advisor did examine the fairness of the price to class members. Nevertheless, the Proxy Statement continues and intimates that, whatever the advisor did, the advisor concurred with NASD's opinion.[47] Yet, according to NASD's Brief, the Board neither obtained such advice nor did it ever retain the services of an independent financial advisor. NASD Br. at 22.

[47] A corporate board must disclose the existence of an appraisal report prepared in preparation of a consolidation or merger. *Bell v. Kirby Lumber Corp.*, 395 A.2d 730 (Del. Ch. 1978).

This statement is more than materially deceptive. The Proxy informed the members, in language clearly designed to mislead, that the Transaction was "fair" and based on advice from an expert who the NASD ***now states was never retained and never provided any counsel about the fairness of the Transaction***. NASD's admission on this issue alone entitles Plaintiff to prevail and, indeed, entitles Plaintiff to summary judgment to the effect that the Proxy Statement was false and misleading.

H. The Amended Complaint States a Claim for Breach of Duty of Care: Defendants Were Grossly Negligent.

Under Delaware law, the business judgment rule is the offspring of the fundamental principle (codified at 8 DGCL § 141(a)) that the business and affairs of a Delaware corporation are managed by its board of directors (in this case, NASD's Board of Governors). In carrying out this role, directors are "charged with an unyielding fiduciary duty to the corporation and its shareholders." *Van Gorkom*, 488 A.2d at 872. The rule itself "is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Id.*

Whether a business judgment is an informed one "turns on whether the directors have informed themselves prior to making a business decision, of all material information reasonably available to them." *Id.* (citation omitted).[48] No Board receives protection for making "an unintelligent or unadvised judgment." *Id.* Thus, the NASD Board had a

[48] In *Oberly v. Kirby*, 592 A.2d 445 (Del. 1991), the Delaware Supreme Court acknowledged that decisions made by the fiduciaries of a nonstock corporation deserved deference similar to the business judgment of directors of for-profit corporations. Moreover, the Court explained that traditional corporate law will govern the activities of a nonstock corporation, and that directors have "a special duty" to advance the goals and purposes of the nonprofit corporation when the entity was established. *Id.* at 472-73.

fiduciary duty to inform itself of all material information before making a decision on the Transaction. "Such obligation does not tolerate faithlessness or self-dealing.

The business judgment rule thus embodies the standard duty of care in the absence of allegations of self-dealing or fraud which implicate the fiduciary obligation of loyalty. *Id.* at 873. If Board members are participating in a transaction that involves self-dealing or allegations of fiduciary obligations of loyalty being breached, the NASD and/or the individual Defendants will have the burden of demonstrating that the Transaction was fair. *Weinberger*, 457 A.2d at 710 (Del. 1983).

Here, Defendants Schapiro and Bruckner as well NASD's other Governors were grossly negligent in failing to inform themselves prior to making a business decision material information reasonably available. *n*In *Smith v. Van Gorkom*, the Supreme Court of Delaware concluded that the board violated the ordinary business judgment standard of care when it approved the sale of a company without sufficient information, time, evaluation and documentation concerning the proposed transaction, and instead relied merely on the assurances and descriptions of the company's Chairman and CEO concerning the reasonableness of the transaction. 488 A.2d at 881. There were a number of things that the board could have done, but did not do. The court noted with concern that the Board did not request a fairness opinion, and otherwise lacked sufficient valuation information to judge the fairness of proposal. *See* 488 A.2d 858, 877 (Del. 1985).

Similarly, NASD violated its ordinary duty here because it too proceeded to authorize the Transaction with little more than, as alleged in the First Amended Complaint, the wishes for such a consolidation by the SEC. The Board's approval was basically the

rubber-stamping of a transaction sought out and negotiated by a conflicted Governor and the NYSE, the principal and unjustly enriched beneficiaries of the Transaction. Like *Van Gorkom*, NASD's Board lacked documentation concerning the Transaction, and no fairness opinion was requested or obtained, *see* NASD Br. at 22, and no independent or credible opinion as to the fairness of the Transaction to class members was ever obtained.

Moreover, the vote of the NASD Board to approve the Transaction violated its "special duty" to advance the historic and well-understood purpose of the NASD. *Oberley*, 592 A.2d at 472-73. Defendants have violated this duty by presenting and approving the consolidation. *Id.*; *see also In re Osteopathic Hospital Ass'n of Del.*, 191 A.2d 333 (Del. Ch. 1963) (rejecting, as an unreasonable use of power, a change in By-Laws that, while facially valid, were contrary to fundamental purpose of non-profit entity), *aff'd*, 195 A.2d 759 (Del. 1963).

To achieve these goals, the NASD Board of Governors sacrificed the historic and essential purpose of the "democratic" NASD to have an elected Board of Governors where "each member, whether ***large or small***, has one vote in the election of these bodies." S.E.C. Release No. 2045, 1939 WL 38197, at *2 (1939), on the altar of efficiency to create a single regulatory body. As the Proxy Statement explained, a "deal would not have been reached with NYSE Group if each member of the new SRO had the right to vote on all Board candidates in elections." Proxy at 8. Given that essential stated purpose of the Transaction is to "establish a single self-regulatory organization to serve as the sole U.S. private-sector provider of member firm regulation for securities firms that do business with the public," the NASD and the individual Defendants eschewed their ordinary fiduciary

duties and their "special duty" to members. It unreasonably exercised authority when proposing to do away with the democratic control by members.

Additionally, the failure of the Proxy Statement to explain why no other deal could have been reached to effectuate a consolidation of the regulatory functions of the two SRO's evidences the failure of the Board to negotiate at arm's length. *See, e.g., T. Rowe Price Recovery Fund, L.P. v. Rubin*, 770 A.2d 536, 554 (Del. Ch. 2000). By accepting as *fait accompli* the end of class member control over the NASD and its historic democratic purpose, the Board of Governors (including Defendants Schapiro and Brueckner) illustrated their self-dealing, lack of loyalty, and gross negligence in the process by which it reached its decision.

I. NYSE Aided and Abetted, As Well as Actively Participated in, NASD's and Individuals Defendants' Breach of Fiduciary Duty.

In order to state a claim, for aiding and abetting a breach of fiduciary duty that will survive a Rule 12(b)(6) motion, plaintiff must allege: (1) the existence of a fiduciary relationship; (2) the fiduciary breached its duty; (3) a defendant, who is not a fiduciary, knowingly participated in a breach; and (4) damages to the plaintiff resulted from the concerted action of the fiduciary and the non-fiduciary. *In re General Motors (Hughes) S'holder Litig.*, 2005 Del. Ch. LEXIS 65, *93 (Del. Ch. May 4, 2005). "A claim of knowing participation need not be pled with particularity. However, there must be factual allegations in the complaint from which knowing participation can be reasonably inferred. If such facts are not pled, then in order to infer knowing participation, the plaintiff must have alleged that the fiduciary breached its duty in an inherently wrongful manner." *Id.* at *94 (citations omitted).

Plaintiff has plead facts that establish NYSE had "knowing participation" in the breaches of fiduciary duty discussed above. The NYSE, and its agents or employees, and especially those representatives who negotiated the Transactions would inherently know the true value of the NASD, NYSE Regulation, Inc. and the fiduciary duties owed by the NASD members of the class.

Plainly, the minimal payment being offered when compared to the value of the consequent control being obtained, along with NASD's annual report listing the Member's Equity at $1.6 billion, is highly indicative of knowledgeable participation for such sophisticated investors. As alleged in the Amended Complaint, moreover, the NYSE helped draft the Proxy Statement and negotiated the terms of the consolidation in addition to actively soliciting, directly and through its membership, NASD's votes in favor of the Transaction. Given these facts, such a sophisticated entity demonstrates its "knowing participation" in the NASD's breaches of fiduciary duty. Inferring such knowing conduct by elite Wall Street entities that have particular skills, understanding, and, in this case, direct access to valuation of assets has been upheld in the context of a motion to dismiss a claim for aiding and abetting. *In Re Ebay Inc. S'holders Litig.*, 2004 Del. Ch. LEXIS 4 (Del. Ch. Jan. 23, 2004); *In Re Shoe-Town, Inc. S'holder Litig.*, 1990 Del. Ch. LEXIS 14 (Del. Ch. Feb. 12, 1990).

Even if these allegations do not establish "knowing participation," the actions of the NASD Defendants satisfy the standard for "inherently wrongful" breaches of fiduciary duty that allow inference of knowing conduct by the NYSE for the allegations to be upheld at the motion to dismiss stage. *See, e.g., In re General Motors (Hughes) Shareholder Litig.*, 2005 Del. Ch. LEXIS 65, *95 (Del. Ch. May 4, 2005). Because the NYSE knew

that class members were receiving grossly inadequate consideration to relinquish control and without a control premium from it was an inherently wrongful breach (as detailed above).

CONCLUSION

For the foregoing reasons, the Court should deny Defendants' motions to dismiss the Amended Complaint.

Respectfully submitted,

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Dated: April 20, 2007

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

STANDARD INVESTMENT CHARTERED, INC., on behalf of itself and all others similarly situated,	
Plaintiffs,	Case No. 07-cv-2014(SWK)
v.	
NATIONAL ASSOCIATION OF SECURITIES DEALERS,INC. (a/k/a "NASD"); NYSE GROUP, INC.; MARY L. SCHAPIRO; RICHARD F. BRUECKNER and BARBARA Z. SWEENEY	**CLASS ACTION**
	JURY TRIAL DEMANDED
Defendants.	

AMENDED CERTIFICATE OF SERVICE

I hereby certify that on this 22nd day of April, 2007, I caused to be served a redacted version of this Memorandum of Law in Opposition to Defendants' Motions to Dismiss the Amended Complaint, which excludes confidential material, through the Court's ECF system, upon all attorneys registered with that system. Due to technical difficulties this Memorandum was not served through the Court's ECF system, on April 20, 2007, as contemplated by the prior Certificate of Service. However, pursuant to the Stipulation filed with the Court on April 20, 2007, opposing counsel were served by electronic mail with an unredacted confidential version of the Plaintiff's Memorandum at 3:16 P.M. on April 20, 2007. In addition, Judge Kram's chambers received a copy by hand delivery on Friday April 20, 2007.

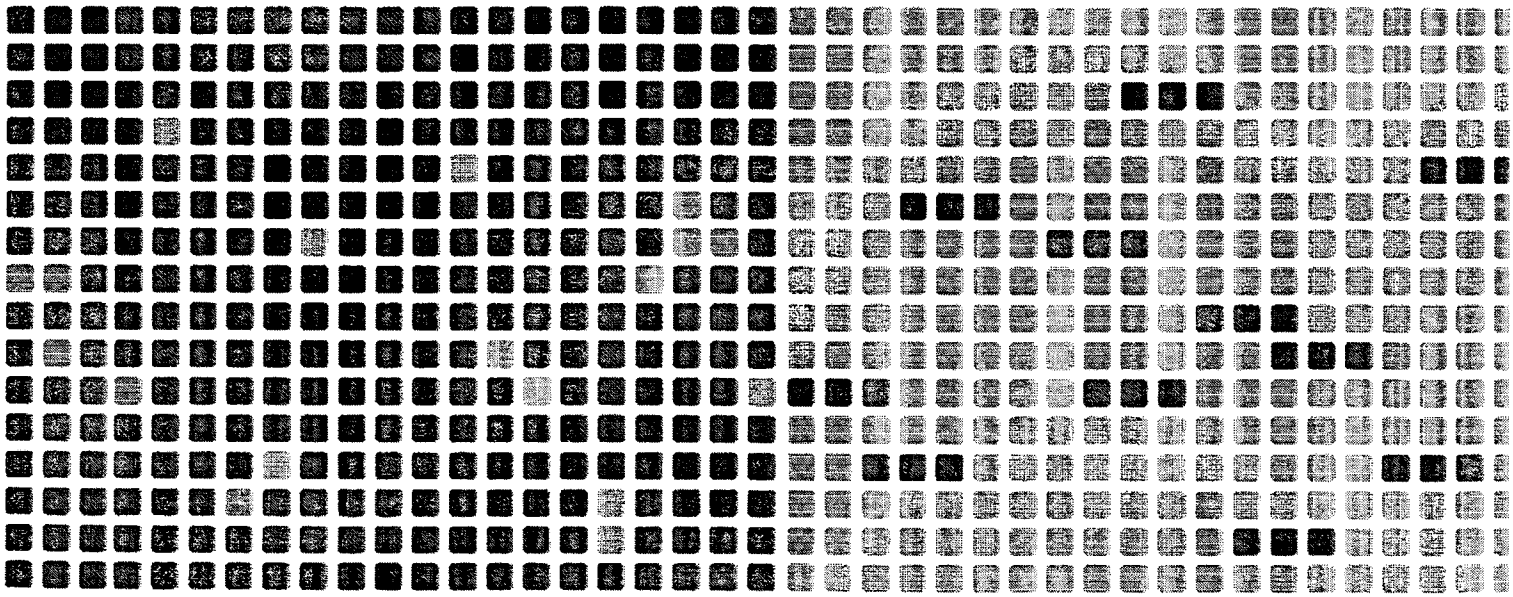
William Anderson

EXHIBITS 1-10
TO
ATTACHMENT "D"

EXHIBIT 1

NASD™

2005 | Annual Financial Report



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Management Report on Financial Operations

OVERVIEW

NASD is the leading private-sector provider of financial regulatory services, dedicated to investor protection and market integrity through effective and efficient regulation. NASD touches virtually every aspect of the securities business—from registering industry participants, to examining securities firms, enforcing both NASD rules and the federal securities laws, and administering the largest dispute resolution forum for investors and firms.

The following discussion and analysis of financial condition and results of operations should be read in connection with the consolidated financial statements and notes thereto included elsewhere in this Annual Financial Report. The 2005 consolidated financial statements reflect the activity of NASD and its consolidated subsidiaries, The Nasdaq Stock Market, Inc. (NASDAQ); NASD Regulation, Inc. (NASDR), NASD Dispute Resolution, Inc. (NASD DR); NASD Investor Education Foundation (the Foundation); and New NASD Holding, Inc. (NASD Holding), which held NASD's Class B interest in The American Stock Exchange LLC (Amex) until December 31, 2004. (References to NASD and its consolidated subsidiaries throughout are collectively referred to as "the Company.")

NASD and NASDAQ are managed and operated as separate, stand-alone companies, each with its own separate board of governors/directors and management. NASD consists of regulatory services and operations and is a self-regulatory organization (SRO). NASDAQ consists of the operations of The NASDAQ Stock Market. The Company views its business as consisting of two segments as defined by Statement of Financial Accounting Standards (SFAS) No. 131, "Disclosures About Segments of an Enterprise and Related Information."

While this report reflects the consolidated operations of the Company, the primary focus is on the NASD segment, including NASDR and NASD DR. This focus is consistent with the steps NASD has taken to divest itself of ownership and operation of securities markets and is intended to highlight discussion of areas that will remain with NASD upon completion of the NASDAQ separation, which is expected in 2006.

For the years ended December 31, 2005 and 2004, the Company's consolidated net income was $293.4 million and $66.5 million, respectively. Included in net income in 2004 is the cumulative effect of a change in accounting principle of ($58.3) million, and for the years ended December 31, 2005 and 2004, (loss) income from discontinued operations of ($0.3) million and $19.7 million, respectively. Income from continuing operations for the years ended December 31, 2005 and 2004 was $293.7 million and $105.1 million, respectively. NASD management, along with the Board of Governors, made a commitment to adopt the provisions of Section 404 of the Sarbanes-Oxley Act of 2002 relating to internal control over financial reporting. With the issuance of this Annual Financial Report, NASD is one of the first tax-exempt organizations to adopt these provisions.

2005 YEAR-IN-REVIEW

In 2005, in addition to performing our core regulatory responsibilities, NASD came closer to completing its separation from NASDAQ. Through a series of transactions, we reduced our ownership stake in NASDAQ common stock to 18.4 percent (generating proceeds of $444.2 million). Through additional transactions in 2006, NASD has reduced its ownership in NASDAQ common stock to 11.4 percent. The U.S. Securities and Exchange Commission (SEC) approved NASDAQ's application to become an exchange on January 13, 2006, subject to certain conditions. We anticipate that NASDAQ will start operating as an exchange later this year, and NASD will complete its transition to becoming primarily a private-sector regulator.

Following are 2005 highlights for NASD in fulfilling its mission of investor protection and market integrity:

- NASD intensified its regulatory focus on sales of mutual funds, variable annuities and 529 College Savings Plans by bringing significant enforcement actions, advocating enhanced point-of-sale transparency and creating tools for investors and brokers aimed at better understanding and accessing information on these products.

- In February 2005, NASD's TRACE (Trade Reporting and Compliance Engine) began disseminating publicly, in real-time, price data for 99 percent of corporate bond trades and on January 9, 2006, NASD implemented full, real-time public dissemination of all TRACE price data. At the same time, NASD significantly expanded the distribution and accessibility of corporate bond information to both individual investors and professional subscribers.

- As part of its ongoing efforts to demystify the corporate, municipal and government bond markets for retail investors, NASD introduced a comprehensive, online learning center called Smart Bond Investing. NASD also introduced two major tools for mutual fund investing, including a new and improved Mutual Fund Expense Analyzer that delivers fee and expense information to investors for virtually all of the more than 18,000 mutual funds and 160 Exchange Traded Funds (ETFs). NASD's new Mutual Fund Breakpoint Search Tool offers investors and brokers an easy way to research eligibility for breakpoint discounts.

- NASD continued to bolster its investor education initiatives by issuing a variety of Investor Alerts on topics ranging from identifying bogus stock tips on cell phones to protecting online brokerage accounts from identity theft.

- The Foundation issued 15 grants totaling $3.4 million, and actively managed the 11 grants awarded in 2004, the Foundation's inaugural year. In addition, the Foundation initiated the Military Education Program with $6.8 million received from the First Command enforcement settlement. In September 2005, the U.S. District Court of the Southern District of New York issued an order allowing the SEC to turn over to the Foundation $55.0 million from its effort to set up an investor education foundation.

- NASD DR saw 6,074 new arbitration claims and 1,253 mediation claims filed, and closed 9,043 arbitration cases and 1,675 mediation cases in 2005. In addition, NASD realized its plan to establish dispute resolution hearing locations in all 50 states—the only SRO forum to do so; at year-end, there were 68 locations in the United States, Puerto Rico, and London.

- NASD worked with the SEC to make the mutual fund point-of-sale disclosure regime less complex and clearer to investors. NASD also advocated its proposed "Profile Plus" disclosure document, drafted in support of the recommendation of the Mutual Fund Task Force that NASD organized.

- In 2005, NASD's Examiner University commenced its first year of operation and graduated its first class, with 123 examiners completing Phase I, 81 completing Phase II, 50 completing Phase III, and 36 completing Phase IV. Examiner University provides a one-year course of classroom and on-the-job training for all incoming NASD examiners, with the goal of making sure that all examiners know as much about a firm and its products at the beginning of an examination as their predecessors knew at the end of one. The result is more efficient, cost-effective and consistent administration of our exam programs. In addition, NASD began an in-depth review of NASD's entire examination program, with the goal of creating a new operating model that is enabled by technology to better identify potential risks by analyzing data and thereby tailoring each exam based upon a member firms risk characteristics.

- With SEC approval, NASD executed a smooth transfer of the Over-the-Counter Bulletin Board (OTCBB) and other OTC Equities, including the pink sheets, (together "OTC Equities") from NASDAQ, effective October 1, 2005. This satisfied another condition of NASDAQ Exchange Registration, further expanded NASD's role in operating industry information services, and put more focus on the regulatory needs of OTC Equities.

- NASD continued to expand its compliance and regulatory related educational offerings in the U.S. and entered into a partnership with the University of Reading in England to establish a European hub for global capital markets regulation and compliance educational programs.

RESULTS OF OPERATIONS

REVENUES

The following table sets forth consolidated revenues by segment and revenue category:

	YEARS ENDED DECEMBER 31,							
	2005				2004			
	NASD	NASDAQ	Consolidating Adjustments	Consolidated	NASD	NASDAQ	Consolidating Adjustments	Consolidated
	(in millions)							
Market services	$ –	$ 653.7	$ (7.7)	$ 646.0	$ –	$ 334.5	$ (2.0)	$ 332.5
Issuer services	–	226.0	(1.5)	224.5	–	205.8	(4.3)	201.5
Regulatory fees	185.5	–	–	185.5	222.8	–	–	222.8
User fees	145.3	–	–	145.3	137.3	–	–	137.3
Transparency services	22.8	–	–	22.8	14.7	–	–	14.7
Contract services	63.4	–	(40.9)	22.5	58.1	–	(53.4)	4.7
Dispute resolution fees	72.9	–	–	72.9	80.2	–	–	80.2
Other fees	7.2	0.2	(0.1)	7.3	14.3	0.1	(12.1)	2.3
Total operating revenue	497.1	879.9	(50.2)	1,326.8	527.4	540.4	(71.8)	996.0
Activity assessment	411.9	–	(12.8)	399.1	230.9	–	–	230.9
Fines	148.5	–	–	148.5	114.4	–	–	114.4
Total revenues	1,057.5	879.9	(63.0)	1,874.4	872.7	540.4	(71.8)	1,341.3
Cost of revenue	(413.5)	(353.9)	12.8	(754.6)	(230.9)	(55.8)	–	(286.7)
Net revenue	$ 644.0	$ 526.0	$ (50.2)	$ 1,119.8	$ 641.8	$ 484.6	$ (71.8)	$ 1,054.6

NASD

NASD net revenues were $644.0 million in 2005, compared with $641.8 million in 2004, an increase of $2.2 million or 0.3 percent.

Operating Revenues

Regulatory fees are used to fund NASD's member regulatory activities, including the regulation of members through examinations, financial monitoring, policymaking, rulemaking and enforcement activities. Regulatory fees include the transaction-based trading activity fee, as well as assessments based on member firm gross income and number of personnel. Regulatory fees were $185.5 million in 2005 compared with $222.8 million in 2004, a decrease of $37.3 million, or 16.7 percent, mainly due to a 25.0 percent rate reduction on the trading activity fee. In November 2004, the trading activity fee was reduced as part of a three-year phase-in of regulatory fee pricing changes, which were instituted to better align NASD's regulatory fees with its functions, efforts, and costs. Trading activity fees decreased from $110.0 million in 2004 to $78.5 million in 2005. Furthermore, due to NASD's overall solid financial performance, NASD issued rebates to its membership of $50.0 million in 2005, up from $30.0 million in the prior year. These rebates are recorded as a reduction of regulatory fees.

User fees include fees charged for initial and annual registrations, qualifications exams, fees associated with NASD-sponsored meetings and conferences, processing of membership applications and charges related to the review of advertisements and corporate filings. User fees were $145.3 million in 2005, compared with $137.3 million in 2004, an increase of $8.0 million, or 5.8

percent. User fees increased due mainly to a change in the rate structure for corporate financing fees, which increased by $4.1 million to $20.0 million in 2005. In 2004, NASD separated first-year registration fees into the initial and annual components and began deferring and amortizing the initial fee component over an estimated customer relationship period. See the "Cumulative Effect of a Change in Accounting Principle" section for further discussion.

Transparency services represent fees charged for services offered through TRACE, NASD's Alternative Display Facility (ADF) and, beginning October 1, 2005, fees associated with the OTC Equities. Transparency services revenues were $22.8 million in 2005 compared with $14.7 million in 2004, an increase of $8.1 million, or 55.1 percent. Included in transparency services in 2005 were revenues of $5.4 million from the OTC Equities. On September 2, 2005, NASD executed the OTCBB and OTC Equities Revocation of Delegation and Asset Transfer and Services Agreement (OTC Equities Agreement) with NASDAQ related to the OTC Equities. The OTC Equities includes OTCBB and is an electronic screen-based quotation service for securities that, among other things, are not listed on The NASDAQ Stock Market or any U.S. national securities exchange. Under the OTC Equities Agreement, effective October 1, 2005, NASD assumed responsibility for the OTC Equities from NASDAQ. NASD has included revenues generated from the OTC Equities within transparency services effective with the transfer on October 1, 2005.

Contract services represent amounts charged for regulatory services provided primarily to NASDAQ and Amex, as well as other exchanges such as the International Stock Exchange and the Chicago Climate Exchange, associated with surveillance, monitoring, legal and enforcement activities. Contract services fees were $63.4 million in 2005 compared with $58.1 million in 2004, an increase of $5.3 million or 9.1 percent. In June 2004 NASD and Amex executed a regulatory services agreement for NASD to provide such services to Amex. In 2005, NASD recognized $20.1 million in revenues from the regulation of Amex, compared with $6.6 million in 2004, as the Amex regulatory agreement became effective in June 2004. Offsetting this increase from Amex was a decline of $3.8 million in NASD's regulation charge to NASDAQ.

Dispute resolution fees totaled $72.9 million in 2005 compared with $80.2 million in 2004, a decrease of $7.3 million, or 9.1 percent. This decrease was driven by a 26.0 percent decline in the number of cases filed combined with a slight decline in the number of closed cases. Dispute resolution closed 9,043 cases in 2005, compared with 9,209 cases in 2004. Dispute resolution fees also include mediation fees, SRO annual fees, neutral training fees and other fees totaling $2.1 million for each year ended December 31, 2005 and 2004, respectively. SRO annual fees relate to the maintenance of dispute resolution services including arbitration and mediation, for SROs. Neutral training fees relate to NASD Dispute Resolution's comprehensive arbitrator and mediator application and training program. In 2004, in connection with the implementation of Emerging Issues Task Force (EITF) No. 00-21, "Revenue Arrangements with Multiple Deliverables," NASD changed its accounting for dispute resolution fees collected on open cases. See the "Cumulative Effect of a Change in Accounting Principle" section for further discussion.

Other fees decreased $7.1 million from 2004 to $7.2 million in 2005. Included in other fees were amounts recognized for administrative services provided to Amex of $4.4 million and $5.4 million for the years ended December 31, 2005 and 2004, respectively. In 2004, NASD and NASDAQ fulfilled their obligations to Amex with respect to the separation of NASDAQ and Amex shared technology applications. As part of this obligation, NASD and NASDAQ agreed to reimburse Amex for up to $29.0 million of costs it incurred to reintegrate its technology applications. In 2004, NASD received $4.6 million from NASDAQ (included in other fees for NASD) and contributed the $4.6 million, along with NASD's matching portion, to Amex in the form of a capital contribution. As of December 31, 2004, this program was fully funded.

Total Revenue and Net Revenue

Activity assessment fee and cost of revenues represent amounts incurred by NASD and owed to the SEC pursuant to Section 31 of the Securities Exchange Act of 1934. Activity assessment fees were $411.9 million in 2005 compared with $230.9 million in 2004, an increase of $181.0 million, or 78.4 percent. This increase was due to the increase in the SEC Section 31 fee rate that NASD collects through the activity assessment. The SEC Section 31 rate changed three times in 2005, resulting in an average rate increase

for the year of 69 percent. The remaining increase is due to the increase in dollar volume trades during 2005 as compared to the prior year. Cost of revenues was $413.5 million in 2005 and $230.9 million in 2004, an increase of $182.6 million, or 79.1 percent. Cost of revenues increased consistently with revenues, as expected.

Fines represent amounts billed as sanctions for rule violations. NASD does not view fines as part of its operating revenues. Fines totaled $148.5 million in 2005 and $114.4 million in 2004, an increase of $34.1 million, or 29.8 percent. NASD's cash collections from fines were $134.3 million, of which $6.8 million was received by the Foundation, in 2005, compared with $103.9 million in 2004. The process that NASD has in place regarding the use of fines is designed to guard against potential conflicts in the organization's collection and use of fine monies. NASD's fine guidelines provide that: (1) all fine monies are collected and segregated from NASD revenues into a separate account, (2) fine monies collected or anticipated are not included in NASD operating revenues and play no role in developing its operating budget, (3) fine monies are not used to fund employee compensation, (4) the use of fine monies is limited to capital expenditures (approved by executive management, the Finance Committee of NASD's Board of Governors or NASD's Board of Governors) and regulatory projects specified by those groups as having a clear and direct link to protecting investors and ensuring market integrity, and (5) NASD reports annually to its Board of Governors the projects and purposes for which fine monies have been used.

NASDAQ

NASDAQ total revenues increased $339.5 million, or 62.8 percent, due to increases in market services of $319.3 million and issuer services of $20.2 million. Market services increased primarily due to increases in execution and trade reporting revenues from the acquisitions of Toll Associates, LLC (Toll) and Instinet Group Incorporated (Instinet). Toll is a holding company that owns a 99.8 percent interest in Brut, LLC (Brut). Instinet owns 100.0 percent of INET Holding Company, Inc., which owns 100.0 percent of INET ATS, Inc. (INET). Also contributing were increases in NASDAQ's execution market share for both NASDAQ-listed securities and securities listed on other exchanges, and an increase in the percentage of share volume reported to NASDAQ's systems, despite a decrease in average daily share volume. Furthermore, NASDAQ Market Center revenues increased from reductions in the liquidity rebate payments for the non-Brut portion and non-INET portion of the NASDAQ Market Center in 2005, which are accounted for as a contra-revenue. NASDAQ's issuer services revenues increased primarily due to increased annual fees from the NASDAQ National and NASDAQ Capital Markets.

CONSOLIDATING ADJUSTMENTS

Consolidating adjustments for 2005 represent the elimination of intercompany revenues between NASD and NASDAQ for regulation charges, the maintenance of TRACE and the OTC Equities platforms, the activity assessment and cost of revenues associated with INET and Brut, and premiums paid by NASD to the NASDAQ Insurance Agency. In 2004, the consolidating adjustments represented the elimination of the regulation charge for NASDAQ and Amex, administrative services provided to Amex and revenues earned by NASDAQ from the maintenance of TRACE. Given the sale of Amex on December 31, 2004, revenues generated from Amex are third-party revenues in 2005 and, thus, not eliminated in consolidation.

EXPENSES

The following table summarizes total operating expenses by segment and category:

	YEARS ENDED DECEMBER 31,							
	2005				2004			
	NASD	NASDAQ	Consolidating Adjustments	Consolidated	NASD	NASDAQ	Consolidating Adjustments	Consolidated
	(in millions)							
Compensation and benefits	$ 352.5	$ 152.1	$ (0.9)	$ 503.7	$ 306.8	$ 148.2	$ (0.2)	$ 454.8
Professional and contract services	147.5	28.8	(4.2)	172.1	118.5	23.7	(3.0)	139.2
Computer operations and data communications	24.3	62.4	–	86.7	24.8	98.9	(0.3)	123.4
Depreciation and amortization	37.6	67.0	–	104.6	39.5	76.3	0.1	115.9
Occupancy	28.3	28.4	(0.1)	56.6	30.4	28.7	–	59.1
General and administrative	60.7	31.3	(0.3)	91.7	49.1	55.0	0.3	104.4
Intercompany	1.6	41.7	(43.3)	–	0.3	45.6	(45.9)	–
Total expenses	$ 652.5	$ 411.7	$ (48.8)	$ 1,015.4	$ 569.4	$ 476.4	$ (49.0)	$ 996.8

NASD

NASD total expenses were $652.5 million in 2005 compared with $569.4 million in 2004, an increase of $83.1 million, or 14.6 percent.

Compensation and benefits increased $45.7 million, or 14.9 percent, from $306.8 million to $352.5 million primarily due to normal pay increases and additional headcount for market regulation and enforcement. In June 2004, NASD added approximately 117 employees related to the Amex regulatory service agreement. NASD had 2,432 employees as of December 31, 2005, and 2,333 employees as of December 31, 2004. Also contributing to the expense increase were costs associated with NASD's defined benefit pension plans due to continued reductions in the interest rate environment.

Professional and contract services increased $29.0 million to $147.5 million, or 24.5 percent, from $118.5 million in 2004. The significant increases in professional and contract services included additional investment manager fees related to NASD's continued diversification of its investment portfolio and costs associated with the Next Generation Program and Sarbanes-Oxley Section 404 compliance.

Computer operations and data communications expense, depreciation and amortization expense, and occupancy expense all remained consistent with prior year.

General and administrative expenses include NASD's expenditures on matters such as travel, supplies and marketing. General and administrative expenses increased by $11.6 million, or 23.6 percent, to $60.7 million in 2005. In February 2005, Amex withdrew $25.0 million on its revolving credit facility with NASD, which has a stated interest rate of 5.0 percent per annum. NASD recognized a loss of $8.6 million on this revolving credit facility representing an adjustment to record this receivable at net realizable value using a market rate of 11.2 percent. Also contributing to the increase in general and administrative expenses were increases in travel expenses, mainly due to NASD's Examiner University program.

NASDAQ

NASDAQ total expenses were $411.7 million for 2005, compared with $476.4 million in 2004, a decrease of $64.7 million, or 13.6 percent. These decreases were primarily due to a reduction in general and administrative expense, computer operations and data communications expense, and depreciation and amortization expense.

General and administrative expense decreased $23.7 million, or 43.1 percent, in 2005 compared with 2004. The decrease in 2005 was primarily due to decisions affecting NASDAQ's real estate subsequent to the acquisition of INET in 2005. These decisions resulted in NASDAQ management deciding to occupy space in its New York office that it had previously intended to vacate. As a result, NASDAQ recorded $12.1 million of income as an offset to general and administrative expenses representing the reversal of the sub-lease reserve for this space. Furthermore, in the fourth quarter of 2004, NASDAQ recorded a loss of $7.4 million for the write-down of the Key West Building to fair market value. Computer operations and data communications expense decreased $36.5 million, or 36.9 percent, in 2005 compared with 2004, due to lower costs from the favorable renegotiation of certain maintenance contracts and hardware leases. Also contributing to the decreases were lower costs associated with NASDAQ's renegotiated contract with MCI, effective in the second quarter of 2004. Depreciation and amortization expense decreased $9.3 million, or 12.2 percent, in 2005 compared with 2004 due to declines in depreciation and amortization expense on equipment associated with NASDAQ's quoting platform and its trading and quoting network, as NASDAQ migrates to lower-cost operating environments as part of its cost-reduction plan.

CONSOLIDATING ADJUSTMENTS

Consolidating adjustments for 2005 represent the elimination of intercompany expenses between NASD and NASDAQ for regulation charges, the maintenance of TRACE and the OTC Equities platforms, and insurance premiums paid by NASD to the NASDAQ Insurance Agency. In 2004, the consolidating adjustments represented the elimination of the regulation charge for NASDAQ and expenses for the maintenance of TRACE.

OTHER INCOME (EXPENSE)

The following table summarizes total other income (expense) by segment and category:

	YEARS ENDED DECEMBER 31,							
	2005				2004			
	NASD	NASDAQ	Consolidating Adjustments	Consolidated	NASD	NASDAQ	Consolidating Adjustments	Consolidated
	(in millions)							
Interest and dividend income	$ 66.6	$ 12.7	$ (6.6)	$ 72.7	$ 42.7	$ 5.9	$ (13.2)	$ 35.4
Interest expense	–	(20.4)	–	(20.4)	(0.3)	(11.5)	–	(11.8)
Net realized investment gains	20.5	–	–	20.5	25.7	–	–	25.7
Gain on NASDAQ common stock sold by NASD	384.4	(0.6)	–	383.8	–	–	–	–
(Loss) gain on NASDAQ warrants	(180.1)	–	0.8	(179.3)	3.9	–	–	3.9
Equity loss from affiliate	(0.2)	–	–	(0.2)	–	–	–	–
Minority interest expense	–	0.2	(43.5)	(43.3)	–	–	(5.1)	(5.1)
Total other income (expense)	$ 291.2	$ (8.1)	$ (49.3)	$ 233.8	$ 72.0	$ (5.6)	$ (18.3)	$ 48.1

NASD

NASD net other income was $291.2 million in 2005, compared with $72.0 million in 2004, an increase of $219.2 million. This increase is due to three transactions consisting of two sales of NASDAQ common stock by NASD and the exercise of warrants under Tranches III and IV. NASD sold 21.1 million shares of NASDAQ common stock in two separate transactions generating aggregate net proceeds of $301.7 million and a gain of $288.0 million. In addition, 6.8 million shares of common stock were issued in connection with the exercise of warrants, generating net proceeds of $102.5 million and a gain of $96.4 million.

Also contributing to the increase in net other income was an increase in interest and dividend income of $23.9 million, which is related to increases in the available-for-sale investments held by NASD from the proceeds generated from the sales of NASDAQ common stock. Offsetting this gain was a loss on NASDAQ warrants of $180.1 million, representing the adjustment to the fair value of the outstanding warrants.

NASDAQ

NASDAQ incurred net other expenses of $8.1 million in 2005 compared with $5.6 million in 2004, with the increase attributable to additional interest expense from the $205.0 million convertible notes issued in April 2005 and the $750.0 million senior-term debt issued in December 2005, in connection with the financing of the INET acquisition.

CONSOLIDATING ADJUSTMENTS

Consolidating adjustments represent the intercompany elimination of dividends recognized by NASD on NASDAQ preferred stock, as well as NASD's sharing of NASDAQ's net income with minority interest partners. Minority interest expense was $43.5 million in 2005 compared with $5.1 million in 2004. The increase in minority interest expense is due to an increase in NASDAQ's net income to $61.7 million in 2005 from $11.4 million in 2004, combined with a decrease in NASD's ownership of NASDAQ common stock from 54.7 percent as of December 31, 2004, to 18.4 percent as of December 31, 2005.

PROVISION FOR INCOME TAXES

As NASD is a tax-exempt organization under the provisions of the Internal Revenue Code Section 501(c)(6), tax expenses reflected in the Company's consolidated financial statements represent the tax expense of NASDAQ. NASDAQ's income tax provision was $44.6 million and $0.7 million for the years ended December 31, 2005 and 2004, respectively. The overall effective tax rate for NASDAQ in 2005 and 2004 was 41.9 percent and 29.3 percent, respectively. The change in NASDAQ's tax provision in 2005 was primarily due to a loss on the restructuring of the $240.0 million convertible notes, a portion of which is not deductible for U.S. income tax purposes. In addition, the effective tax rate was reduced in 2004 by the realization of research and development tax credits, as well as a reduction of a valuation allowance related to a foreign net operating loss carryforward.

DISCONTINUED OPERATIONS

Discontinued operations in the Company's consolidated statements reflect charges taken by both NASD Holding and NASDAQ. See the table below for a breakdown by company and year:

	YEARS ENDED DECEMBER 31, 2005	2004
	(in millions)	
Discontinued Operations:		
NASD Holding	$ (0.3)	$ 10.1
NASDAQ	–	9.6
Total	$ (0.3)	$ 19.7

NASD

NASD Holding's net (loss) income from discontinued operations relates to the disposition of Amex, which closed on December 31, 2004. The net income of $10.1 million in 2004 represented the net income generated by Amex for the year, net of intercompany eliminations and taxes, offset by an additional estimated loss on disposal of $6.8 million. In 2005, NASD Holding incurred approximately $0.3 million of additional expenses related to the disposition of Amex, mainly for transaction costs. See Note 15, "Discontinued Operations," to the consolidated financial statements for further discussion.

NASDAQ

NASDAQ's net loss from discontinued operations in 2004 represented amounts associated with the disposal of NASDAQ Europe. As a result of its strategic review, NASDAQ supported the closing of the market operated by NASDAQ Europe. These operations were wound down pursuant to a transition plan approved by the Belgian Banking and Finance Commission. As NASDAQ Europe was winding down its market operations, NASDAQ reached an agreement to transfer all of NASDAQ's shares in NASDAQ Europe to one of the original investors in NASDAQ Europe. The transfer of shares was completed in December 2003. In 2004, NASDAQ released a reserve previously held to satisfy any potential claims against NASDAQ associated with the wind-down of NASDAQ Europe. See Note 15, "Discontinued Operations," to the consolidated financial statements for further discussion.

CUMULATIVE EFFECT OF A CHANGE IN ACCOUNTING PRINCIPLE

In June 2003, the Emerging Issues Task Force finalized EITF No. 00-21, which became effective for NASD's consolidated financial statements on January 1, 2004. This accounting pronouncement requires that revenue arrangements be reviewed to determine (a) how the arrangement consideration should be measured, (b) whether the arrangement should be divided into separate units of accounting, and (c) how the arrangement consideration should be allocated among the separate units of accounting. Once each element of a revenue arrangement has been identified, EITF No. 00-21 requires companies to recognize the revenue for such element in accordance with existing U.S. generally accepted accounting principles. EITF No. 00-21 does not address when the criteria for revenue recognition are met or provide guidance on the appropriate revenue recognition convention for a given unit of accounting. NASD performed a comprehensive review of all revenue arrangements in 2004 and concluded that this new accounting pronouncement was applicable to NASD's registration and dispute resolution fees.

As a result of this implementation, NASD changed its method of revenue recognition for the initial fee component of first-year registration fees and amounts collected on open dispute resolution cases. As part of this implementation, NASD began deferring and amortizing these elements over an estimated customer relationship period. With this change, NASD recognized a one-time cumulative effect of a change in accounting principle, as of January 1, 2004, of a combined ($58.3) million. The impact to 2004 revenues for registrations and dispute resolution fees was not significant.

LIQUIDITY AND CAPITAL RESOURCES

Consistent with the Company's operation of its business segments as separate stand-alone companies, each with its own corporate governance, NASD and NASDAQ separately manage their liquidity and capital resources. Each segment's Board has approved its respective investment policies for internally and externally managed portfolios.

NASD

NASD's investment policy has been developed based on best practices as applied to its investment objectives. The NASD Investment Committee (Investment Committee), whose members have extensive background and experience in the investment community, provides overall guidance and advice in determining the appropriate policy, guidelines and allocation for these investments. NASD

engages an investment consultant to support the Investment Committee in the areas of policy and guidelines, and to monitor the performance of the portfolio and investment managers, including periodic selection and evaluation of asset managers.

NASD's investment policy is reviewed annually by its Board of Governors and was re-approved on July 21, 2005. The goal of NASD's investment policy is to generate long-term returns to be used to support NASD operations for the benefit of investors and members, to preserve the real purchasing power of those funds for future contingencies and to maintain financial balance sheet strength. Portfolio returns may be used to achieve these goals and for other strategic or operational purposes. NASD seeks to maintain a broadly diversified investment portfolio. To this end, the portfolio includes absolute return-oriented investments, the goals of which are to post a positive return in both strong and weak market environments, and particularly to protect capital in down market environments. NASD's targeted investment portfolio allocations are 35.0 to 50.0 percent equities, 10.0 to 20.0 percent fixed income, and 35.0 to 50.0 percent alternative investments.

NASD's investment policy guidelines prohibit the purchase of any debt or equity interest in an entity that derives more than 25.0 percent of its gross revenue from stock exchanges and the combined broker-dealer and/or investment advisory businesses of all its subsidiaries and affiliates. The guidelines also prohibit the purchase of any security during its initial public offering or distribution. The guidelines further contain a proxy voting policy and specify permissible holdings, market capitalization constraints, and credit quality standards, as appropriate, for each asset class in the portfolio, all of which are monitored by the Investment Committee. The investment policy guidelines are reviewed annually by the Investment Committee to ensure the relevance of its content to current capital market conditions.

NASDAQ

NASDAQ's treasury department manages NASDAQ's capital structure, funding, liquidity, collateral, and relationships with bankers, investment advisors and creditors. The NASDAQ Board of Directors approved an investment policy for NASDAQ and its subsidiaries for internally and externally managed portfolios. The goal of the policy is to maintain adequate liquidity at all times and to fund current budgeted operating and capital requirements and to maximize returns. All securities must meet credit rating standards as established by the policy and must be denominated in subsidiary specific currencies. The investment portfolio duration must not exceed 18 months. Since October 2003, the policy prohibits the purchasing of any investment in equity securities. The policy also prohibits any investment in debt interest in an entity that derives more than 25.0 percent of its gross revenue from the combined broker-dealer and/or investment advisory businesses of all of its subsidiaries and affiliates. NASDAQ's Board of Directors reviews its investment policy annually and re-approved it on January 17, 2006. NASDAQ also periodically reviews its investments and investment managers.

QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Market risk represents the risks of changes in value of a financial instrument, derivative or non-derivative, caused by fluctuations in interest rates, foreign exchange rates and equity prices. As of December 31, 2005, investments in the Company's consolidated financial statements consisted of equities, U.S. Treasury securities, obligations of U.S. government-sponsored enterprises and other financial instruments.

The Company's primary market risk relates to its investment portfolio and outstanding debt. The Company's investments and outstanding debt are impacted by fluctuations in the equities markets, interest rates and inflation.

NASD

NASD's investment portfolio contained fixed income securities that have a duration, or weighted-average maturity of cash flows, of approximately 3.3 years as of December 31, 2005. Duration is a measure of the sensitivity of a fixed income portfolio to a change in interest rates: for NASD, every 100-basis-point change in interest rates, a portfolio with a duration of 3.3 years is expected to

change inversely by 3.3 percent. NASD believes that any decline in the value of its fixed income securities due to a 100-basis-point increase in interest rates should be largely offset by the portfolio's yield of approximately 5.1 percent.

NASD reviews its investment portfolio for other-than-temporary declines on a quarterly basis. Based on these reviews, NASD recorded impairment charges for other-than-temporary declines of $23.8 million and $3.1 million in 2005 and 2004, respectively. NASD management believes that other-than-temporary fluctuations in market indices could have a significant impact on its investment portfolio, earnings and cash flows. As of December 31, 2005, NASD had no significant foreign currency exposure or related hedges. NASD investment policy does allow for investments in derivative instruments, including options, interest rate swaps and futures contracts. As of December 31, 2005 and 2004, NASD's investments in such instruments were not material to the consolidated financial statements.

NASD is exposed to credit risk from third parties, including its members, NASDAQ and Amex. These parties may default on obligations to NASD due to bankruptcy, lack of liquidity, operational failure, or other reasons. In addition, NASD has a revolving credit facility receivable from Amex for $25.0 million as of December 31, 2005. This revolving credit facility accrues interest at a fixed rate of 5.0 percent, and both interest and principal are due in October 2011. NASD performed a valuation of this revolving credit facility on the date of issuance, and estimated its fair market value to be $16.4 million, representing the net realizable value using a market rate of interest of 11.2 percent. For the year ended December 31, 2005, NASD recognized interest income of $1.6 million and as of December 31, 2005, the fair value was $18.0 million.

NASD has a line of credit of up to $50.0 million that has a variable interest rate; however, as of December 31, 2005 and 2004, no amounts were outstanding under this credit agreement.

NASDAQ

At December 31, 2005, NASDAQ's investments consisted of fixed income instruments with an average duration of 0.3 years. At December 31, 2005, NASDAQ's $205.0 million convertible notes and $240.0 million convertible notes specified a fixed interest rate until October 22, 2012, and for NASDAQ's $750.0 million senior-term debt a floating interest rate until maturity in 2011. These investment securities and outstanding debt obligations are subject to interest rate risk and fair values may fluctuate with changes in interest rates. NASDAQ management does not believe that a 100-basis-point fluctuation in market interest rates will have a material effect on the carrying value of its investment portfolio or outstanding debt obligations as of December 31, 2005. However, the fair value of NASDAQ's debt obligations exceeds its carrying value. NASDAQ does not currently hedge any variable interest rates on either the investment portfolio or debt obligations.

As of December 31, 2005, NASDAQ had no significant foreign currency exposure or related hedges. NASDAQ periodically evaluates its hedging policies and may choose to enter into future transactions. NASDAQ is exposed to credit risk from third parties, including customers, counterparties and clearing agents. These parties may default on their obligations to NASDAQ due to bankruptcy, lack of liquidity, operational failure or other reasons. In particular, NASDAQ's subsidiaries, Brut and INET, may be exposed to credit risk, due to the default of trading counterparties in connection with the external routing and agency brokerage services Brut and INET provide its customers. While NASDAQ is not exposed to counterparty risk for trades executed on The NASDAQ Market Center, NASDAQ is exposed to counterparty risk in connection with trades executed on or through the Brut ECN and INET ECN systems, or Brut and INET System Trades, given that Brut and INET act as central counterparties on an agency basis for these trades.

CASH FLOWS

Both NASD and NASDAQ primarily rely on cash flows from operations to provide working capital for current and future operations. The Company's net cash provided by operating activities was $268.6 million and $156.2 million for 2005 and 2004, respectively. Net cash used in investing activities was $1,085.4 million and $364.9 million, respectively; net cash provided by (used in) financing

activities was $989.0 million and ($0.2) million for 2005 and 2004, respectively. See the table below for total cash flows by segment between years:

	YEARS ENDED DECEMBER 31,					
	2005			2004		
	NASD	NASDAQ	Total	NASD	NASDAQ	Total
			(in millions)			
Operating:						
Continuing	$ 148.0	$ 120.9	$ 268.9	$ 46.5	$ 107.5	$ 154.0
Discontinued operations	(0.3)	–	(0.3)	(7.4)	9.6	2.2
Total operating	147.7	120.9	268.6	39.1	117.1	156.2
Investing	(132.0)	(953.4)	(1,085.4)	(163.6)	(201.3)	(364.9)
Financing	49.5	939.5	989.0	6.3	(6.5)	(0.2)
Total	$ 65.2	$ 107.0	$ 172.2	$ (118.2)	$ (90.7)	$ (208.9)

NASD

Cash and cash equivalents and available-for-sale investments totaled $1,904.3 million as of December 31, 2005, compared with $1,282.3 million as of December 31, 2004, an increase of $622.0 million, or 48.5 percent. This increase was primarily due to the receipt of $301.7 million associated with the sales of NASDAQ common stock, $102.5 million from the exercise of warrants, $40.0 million from NASDAQ for the partial payment on the Series C Cumulative Preferred Stock and $147.7 million in operating cash flows.

NASD generated cash inflows from operating activities of $147.7 million, compared with $39.1 million in the prior year. The increase was due to changes in working capital, namely an increase in the SEC payable associated with rate changes during the year, combined with net income (before depreciation and amortization) generated during the period. NASD incurred investing cash outflows of $132.0 million in 2005 and $163.6 million in 2004. NASD invested the majority of the proceeds generated from the sale of NASDAQ common stock and exercise of warrants into its available-for-sale investments. In addition, NASD incurred capital expenditures of $41.0 million, which included $18.0 million paid to NASDAQ for an office building (Key West) adjacent to its Rockville, Maryland facility. Cash inflows from financing activities were $49.5 million in 2005 and $6.3 million in 2004. Cash inflows from financing activities in 2005 include the partial repayment of Series C Cumulative Preferred Stock from NASDAQ.

NASD's working capital was $1,416.1 million as of December 31, 2005, and $1,009.5 million as of December 31, 2004. NASD has been able to generate sufficient funds from operations to meet working capital requirements. NASD has a $50.0 million line of credit available through November 2006, if it temporarily needs liquidity to meet its current obligations. NASD believes that the liquidity provided by existing cash and cash equivalents, investments and cash generated from operations will provide sufficient capital to meet current and future operating requirements.

NASDAQ

Cash and cash equivalents and available-for-sale investments totaled $344.6 million as of December 31, 2005, compared with $233.1 million as of December 31, 2004, an increase of $111.5 million, or 47.8 percent. This increase was primarily due to the receipt of funds from employee stock options exercised, the sale of the Key West building to NASD and positive cash flows generated from operations. Partially offsetting these increases were the payment for the partial redemption of NASDAQ's Series C Cumulative Preferred Stock and payments made for the acquisitions of INET and Carpenter Moore.

Cash flows from operating activities totaled $120.9 million and $117.1 million in 2005 and 2004, respectively. The increase in operating cash flows was primarily due to an increase in net income. Cash used in investing activities was $953.4 million and $201.3 million in 2005 and 2004, respectively. The increase in cash used in investing activities was due to the acquisitions of INET and Carpenter Moore, completed during 2005. NASDAQ paid $934.5 million and direct acquisition costs of $34.3 million for INET and paid $27.5 million for Carpenter Moore. In 2004, NASDAQ acquired Brut for $190.0 million, plus post-closing adjustments. During 2005, NASDAQ purchased $591.6 million of available-for-sale investments and $32.0 million of held-to-maturity investments. Capital expenditures and proceeds from sales of property and equipment were $25.4 million and $18.0 million, respectively, in 2005. Investing activities also included proceeds of $585.4 million and $62.7 million from the redemption and maturities of available-for-sale investments and held-to-maturity investments, respectively, in 2005.

Cash provided by (used in) financing activities was $939.5 million and ($6.5) million in 2005 and 2004, respectively. The increase in 2005 was due to the issuances of the $750.0 million senior-term debt in December 2005 and the $205.0 million convertible notes in April 2005, partially offset by the partial redemption of NASDAQ's Series C Cumulative Preferred Stock and the redemption of the $25.0 million senior notes. In 2005, NASDAQ also received proceeds from the issuances of common stock, primarily from employee stock option exercises.

Working capital (calculated as current assets, reduced for held-to-maturity investments classified as current assets, less current liabilities) was $271.6 million as of December 31, 2005, compared with $169.3 million as of December 31, 2004. NASDAQ has been able to generate sufficient funds from operations to meet working capital requirements. NASDAQ has a $75.0 million five-year revolving line of credit obtained in connection with the financing of the INET acquisition. NASDAQ believes that the liquidity provided by existing cash and cash equivalents, investments, and cash generated from operations will provide sufficient capital to meet current and future operating requirements. In conjunction with the issuance of the $750.0 million senior-term debt, NASDAQ prepaid in full the $25.0 million senior notes and recorded a loss on the early extinguishment of the $25.0 million senior notes of approximately $1.1 million, which is recorded in general and administrative expense in the consolidated statements of income.

On February 15, 2006, NASDAQ issued 7.0 million shares in a public offering of its common stock, received net proceeds of $268.9 million and used $104.7 million of these proceeds to redeem the Series C Cumulative Preferred Stock from NASD. NASDAQ plans to use the remaining proceeds for general corporate purposes, including potential acquisitions.

CONTRACTUAL OBLIGATIONS AND CONTINGENT COMMITMENTS

NASD

NASD has contractual obligations to make future payments under investments in limited partnerships, minimum rental commitments under non-cancelable operating leases and other obligations. A summary of those contractual obligations is provided below:

	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
			(in millions)		
Commitments to investments in limited partnerships	$ 69.7	$ 22.9	$ 31.5	$ 13.6	$ 1.7
Minimum rental commitments under non-cancelable operating leases, net	202.8	19.1	34.6	33.1	116.0
Minimum rental commitments under capitalized leases	0.9	0.8	0.1	–	–
Information and technology services agreement	132.0	21.0	41.0	37.0	33.0
Total	$ 405.4	$ 63.8	$ 107.2	$ 83.7	$ 150.7

Investments in limited partnerships represent the expected funding of NASD's total commitment to seven investments in limited partnerships. The majority of the non-cancelable operating leases contain escalation clauses based on increases in property taxes and building operating costs.

NASDAQ

NASDAQ has contractual obligations to make future payments under debt obligations, minimum rental commitments under non-cancelable operating leases, and other obligations, and has contingent commitments under a variety of arrangements. The following table shows these contractual obligations at December 31, 2005:

	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
			(in millions)		
Long-term debt by contractual maturity	$ 1,195.0	$ 7.5	$ 15.0	$ 15.0	$ 1,157.5
Minimum rental commitments under non-cancelable operating leases, net	237.6	33.2	44.5	37.4	122.5
Other long-term obligations	26.8	14.8	9.3	2.7	–
Total	$ 1,459.4	$ 55.5	$ 68.8	$ 55.1	$ 1,280.0

NASDAQ RESTRUCTURING

On January 13, 2006, the SEC approved NASDAQ's application for registration as a national securities exchange (Exchange Registration). NASDAQ will begin operating as an exchange once it meets conditions imposed by the SEC. Upon effectiveness of Exchange Registration, NASDAQ will redeem the Series D Preferred Stock and NASD will no longer have voting control over NASDAQ. As a result, NASD will cease consolidating NASDAQ and will have reduced its ownership of NASDAQ to any remaining shares underlying the unexercised warrants for Tranche IV.

Previous NASD transactions in NASDAQ stock included sales of NASDAQ common stock and warrants in 2000 and 2001. As part of these transactions, NASD issued 10,806,494 warrants to purchase up to 43,225,976 shares of NASDAQ common stock from NASD in four tranches. In March 2002, NASD sold 33.8 million shares of NASDAQ common stock to NASDAQ and received total consideration of $305.2 million in cash, 1,338,402 shares of Series A Cumulative Preferred Stock and one share of Series B Preferred Stock.

In November 2004, NASD and NASDAQ entered into an exchange agreement pursuant to which NASD exchanged 1,338,402 shares of Series A Cumulative Preferred Stock for 1,338,402 shares of newly issued Series C Cumulative Preferred Stock. The Series C Cumulative Preferred Stock accrues quarterly dividends at an annual rate of 3.0 percent for all periods until July 1, 2006, and at 10.6 percent thereafter. In December 2005, NASD exchanged its one share of Series B Preferred Stock for one newly issued share of Series D Preferred Stock, which had terms substantially similar to the terms of the Series B Preferred Stock.

Series C Cumulative Preferred Stock

On April 21, 2005, NASD and NASDAQ entered into a Stock Repurchase and Waiver Agreement whereby NASD consented to the financing used in connection with the acquisition of Instinet. In exchange for the waiver, NASDAQ repurchased 384,932 shares of its Series C Cumulative Preferred Stock from NASD for approximately $40.0 million.

On February 15, 2006, NASDAQ redeemed all remaining outstanding shares of its Series C Cumulative Preferred Stock from NASD, as NASDAQ was required to redeem it after the closing of the public offering of common stock, which took place on the same date. The total redemption price was $104.7 million.

Sales of NASDAQ Common Stock

On February 15, 2005, NASDAQ completed an underwritten secondary offering of 16,586,980 shares of common stock owned by NASD and an additional 3,246,536 shares of common stock owned by certain other selling stockholders, who had purchased the shares in NASDAQ's private placements in 2000 and 2001. NASDAQ, its officers or other employees did not sell any shares in the secondary offering. NASD received net proceeds of $140.4 million and recognized a gain on the sale of subsidiary stock of $133.6 million. As part of this offering, NASDAQ incurred legal fees of $0.6 million, resulting in a consolidated gain of $133.0 million.

On November 16, 2005, NASD completed a block sale of 4.5 million shares of NASDAQ common stock. NASDAQ, its officers or other employees did not sell any shares in the secondary offering. NASD received net proceeds of $161.3 million from this sale and recognized a gain on sale of subsidiary stock of $154.4 million.

On February 15, 2006, NASD sold 3,505,886 shares of NASDAQ common stock in NASDAQ's public offering. NASD received net proceeds of $129.1 million and recognized a gain on sale of subsidiary stock of $121.8 million.

On March 2, 2006, the underwriters for NASDAQ's public offering exercised their option and purchased an additional 1,042,142 shares of common stock from NASD. NASD received net proceeds of $40.0 million on this sale and recognized a gain on sale of subsidiary stock of $34.8 million.

Warrants to Purchase NASDAQ Common Stock from NASD

Tranche I expired on June 27, 2003, and prior to the expiration, NASD issued 35,830 shares of NASDAQ common stock for the exercise of warrants, generating proceeds of $0.5 million and a gain of $0.4 million. Upon expiration of Tranche I, 10,770,664 shares of common stock underlying unexercised warrants reverted back to NASD. Tranche II expired on June 25, 2004, and 6,750 shares of NASDAQ common stock were issued following the exercise of warrants generating proceeds and a gain of $0.1 million. Following expiration of Tranche II, 10,799,744 shares of common stock underlying the unexercised warrants reverted back to NASD. Tranche III expired on June 27, 2005, and NASD issued 6,741,894 shares of NASDAQ common stock for exercises of warrants, generating proceeds of $101.1 million and a gain of $95.2 million. Upon expiration of Tranche III, 4,064,600 shares of common stock underlying unexercised warrants reverted back to NASD. Tranche IV expires on June 27, 2006. As of December 31, 2005, NASD issued 87,675 shares of NASDAQ common stock for exercises of warrants under Tranche IV, generating proceeds to NASD of $1.4 million and a gain of $1.2 million.

The table below summarizes the effect of all transactions executed by NASD in relation to the NASDAQ restructuring through March 31, 2006.

EFFECT OF NASDAQ RESTRUCTURING ACTIVITIES (DOLLARS IN MILLIONS)

	NASDAQ SHARES OWNED BY NASD					
	NASD Ownership %	Fully Diluted %	NASDAQ Shares Not Underlying Warrants	NASDAQ Shares Underlying Warrants	Total NASDAQ Shares Owned by NASD	Cash Proceeds to NASD
As of 12/31/99 after Stock Split	**100.0%**	**100.0%**	**100,000,000**	**–**	**100,000,000**	**$ –**
Phase I – Shares			(323,796)	–	(323,796)	3.5
Phase I – Warrants			(25,661,396)	25,661,396	–	68.7
Balance / Cumulative Impact, 12/31/00	**80.6%**	**59.9%**	**74,014,808**	**25,661,396**	**99,676,204**	**72.2**
Phase II – Shares			(4,219,795)	–	(4,219,795)	53.5
Phase II – Warrants			(17,564,580)	17,564,580	–	59.9
Hellman & Friedman			(18,461,538)	–	(18,461,538)	240.0
Balance / Cumulative Impact, 12/31/01	**68.9%**	**30.2%**	**33,768,895**	**43,225,976**	**76,994,871**	**425.6**
NASDAQ Share Buyback – March 2002*			(33,768,895)	–	(33,768,895)	305.2
Warrant Exercises – Tranche I			–	(20,830)	(20,830)	0.3
Balance / Cumulative Impact, 12/31/02	**55.2%**	**0.0%**	**–**	**43,205,146**	**43,205,146**	**731.1**
Warrant Exercises – Tranche I			–	(15,000)	(15,000)	0.2
Warrant Expiration – Tranche I			10,770,664	(10,770,664)	–	–
Balance / Cumulative Impact, 12/31/03	**55.0%**	**13.7%**	**10,770,664**	**32,419,482**	**43,190,146**	**731.3**
Warrant Exercises – Tranche II			–	(6,750)	(6,750)	0.1
Warrant Expiration – Tranche II			10,799,744	(10,799,744)	–	–
Balance / Cumulative Impact, 12/31/04	**54.7%**	**27.3%**	**21,570,408**	**21,612,988**	**43,183,396**	**731.4**
Secondary Offering – February 2005			(16,586,980)	–	(16,586,980)	140.4
Preferred Stock Paydown			–	–	–	40.0
Warrant Exercises – Tranche III			–	(6,741,894)	(6,741,894)	101.1
Warrant Expiration – Tranche III			4,064,600	(4,064,600)	–	–
Block Trade – November 2005			(4,500,000)	–	(4,500,000)	161.3
Warrant Exercises – Tranche IV			–	(87,675)	(87,675)	1.4
Balance / Cumulative Impact, 12/31/05	**18.4%**	**–**	**4,548,028**	**10,718,819**	**15,266,847**	**1,175.6**
Preferred Stock Payoff			–	–	–	104.7
Public Offering – February 2006			(3,505,886)	–	(3,505,886)	129.1
Public Offering – March 2006			(1,042,142)	–	(1,042,142)	40.0
Warrant Exercises – Tranche IV			–	(202,277)	(202,277)	3.2
Balance / Cumulative Impact, 3/31/06	**11.4%**	**–**	**–**	**10,516,542**	**10,516,542**	**1,452.6**
Warrant Exercises – Tranche IV**				(10,516,542)	(10,516,542)	168.3
Balance / Cumulative Impact, Proforma	**–**	**–**	**–**	**–**	**–**	**$ 1,620.9**

* In connection with the March 2002 share buyback, NASD also received 1,338,402 shares of Series C Cumulative Preferred Stock and one share of Series D Preferred Stock.

** Assumes full exercise of the remaining outstanding warrants under Tranche IV prior to expiration in June 2006.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of the Company's financial statements in conformity with GAAP in the U.S. requires management to adopt accounting principles and make estimates and judgments to develop amounts reported in the financial statements and accompanying notes.

The Company periodically reviews the application of its accounting policies and evaluates the appropriateness of the estimates that are required to prepare the financial statements. The Company believes its estimates and judgments are reasonable; however, actual results and the timing of recognition of such amounts could differ from those estimates.

The Company's significant accounting policies are described in Note 2, "Summary of Significant Accounting Policies," to the consolidated financial statements. The following provides information about the Company's critical accounting policies, which are defined as those reflective of significant judgments and uncertainties that could result in materially different results under different assumptions and conditions. At the consolidated level, the Company has determined that the critical accounting policies are those that cover investments, software costs, goodwill and intangible assets, impairment of long-lived assets, revenue recognition and pension benefits.

INVESTMENTS

Under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," management determines the appropriate classification of investments at the time of purchase. Investments for which the Company does not have the intent or ability to hold to maturity are classified as available-for-sale and are carried at fair value, with any unrealized gains and losses, net of tax, reported as a separate component of members' equity. Investments for which the Company has the intent and ability to hold to maturity are classified as held-to-maturity and are carried at amortized cost. The amortized cost of debt securities classified as held-to-maturity is adjusted for amortization of premiums and accretion of discounts. Fair value is determined based on quoted market prices when available, or if quoted market prices are not available, on discounted expected cash flows using market rates commensurate with the credit quality and maturity of the investment. Realized gains and losses on sales of securities are included in earnings using the average cost method. Amounts due to or from the custodial agent relate to security trades executed prior to the balance sheet date, but not yet settled.

The Company regularly monitors and evaluates the realizable value of its securities portfolio. When assessing for other-than-temporary declines in value, the Company considers such factors as the extent of the decline in value, the duration for which the market value had been less than cost, the performance of the investee's stock price in relation to the stock price of its competitors within the industry and the market in general, any news that has been released specific to the investee and the outlook for the overall industry in which the investee operates. The Company also reviews the financial statements of the investee to determine if the investee is experiencing financial difficulties. If events and circumstances indicate that a decline in the value of these assets has occurred and is deemed other-than-temporary, the carrying value of the security is reduced to its fair value and the impairment is charged to earnings.

SOFTWARE COSTS

Significant purchased application software, and operational software that is an integral part of computer hardware, are capitalized and amortized using the straight-line method over their estimated useful lives, generally two to seven years. All other purchased software is charged to expense as incurred. In accordance with AICPA Statement of Position No. 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," the Company capitalizes internal computer software development costs incurred during the application development stage. Computer software costs incurred prior to or subsequent to the application development stage are charged to expense as incurred.

GOODWILL AND INTANGIBLE ASSETS, NET

NASDAQ's business acquisitions typically result in the recording of goodwill and other intangible assets, and the recorded values of those assets may become impaired in the future. As of December 31, 2005, goodwill totaled $961.9 million and intangible assets, net of accumulated amortization, totaled $217.2 million. The determination of the value of such intangible assets requires management to make estimates and assumptions that affect the consolidated financial statements. The Company assesses potential impairments to intangible assets when there is evidence that events or changes in circumstances indicate that the carrying amount of an asset may not be recovered. Judgments regarding the existence of impairment indicators and future cash flows related to intangible assets are based on operational performance of NASDAQ's acquired businesses, market conditions and other factors. Although there are inherent uncertainties in this assessment process, the estimates and assumptions we use are consistent with NASDAQ's internal planning. If these estimates or their related assumptions change in the future, NASDAQ may be required to record an impairment charge on all or a portion of goodwill and intangible assets. Impairment exists if the carrying value of the indefinite-lived intangible asset exceeds its fair value. For intangible assets subject to amortization, impairment is recognized if the carrying amount is not recoverable and the carrying amount exceeds the fair value of the intangible asset.

IMPAIRMENT OF LONG-LIVED ASSETS

The Company reviews its long-lived assets for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." In the event facts and circumstances indicate that long-lived assets or other assets may be impaired, an evaluation of recoverability would be performed. If an evaluation were required, the estimated future undiscounted cash flows associated with the asset would be compared to the asset's carrying amount to determine if a write-down is required. If the evaluation indicated impairment, the Company would prepare a discounted cash flow analysis to determine the amount of the impairment.

REVENUE RECOGNITION AND COST OF REVENUE

Market Services

Market services revenues are derived from NASDAQ Market Center and NASDAQ Market Services Subscriptions revenues. NASDAQ Market Center revenues are variable, based on service volumes, and recognized as transactions occur. NASDAQ Market Services Subscriptions revenues are based on the number of presentation devices in service and quotes delivered through those devices. NASDAQ Market Services Subscriptions revenues are recognized in the month that information is provided. These revenues are recorded net of amounts due under revenue-sharing arrangements with market participants. Pursuant to EITF No. 99-19, "Reporting Revenue Gross as Principal vs. Net as an Agent," NASDAQ records execution revenues from transactions executed through Brut and INET on a gross basis in revenues and records expenses such as liquidity rebate payments as cost of revenues as both Brut and INET act as principal. Before the second quarter of 2005, NASDAQ reported other execution revenues net of liquidity rebates since NASDAQ does not act as principal.

Issuer Services

Issuer services revenues include annual fees, initial listing fees (IL) and listing of additional shares (LAS) fees. Annual fees are recognized ratably over the following 12-month period. IL and LAS fees are recognized on a straight-line basis over estimated service periods of six and four years, respectively, based on historical listing experience. Issuer services also include commission income from NASDAQ Insurance Agency. Commission income is recognized when coverage becomes effective, the premium due under the policy is known or can be reasonably estimated, and substantially all required services related to placing the insurance have been provided. The effect on income of subsequent premium adjustments, including policy cancellations, is recorded when the adjustment is known. Fee income for services other than placement of insurance coverage is recognized as those services are

provided. Broker commission adjustments and commissions on premiums billed directly by underwriters are recognized when such amounts can be reasonably estimated.

NASDAQ receives license fees for its trademark licenses related to the QQQQ and other financial products linked to NASDAQ indexes issued in the U.S. and abroad. NASDAQ primarily has two types of license agreements: transaction-based licenses and asset-based licenses. Transaction-based licenses are generally renewable long-term agreements. Customers are charged based on transaction volume, a minimum contract amount, or both. If a customer is charged based on transaction volume, NASDAQ recognizes revenue when the transactions occur. If a customer is charged based on a minimum contract amount, NASDAQ recognizes revenue on a pro-rata basis over the licensing term. Asset-based licenses are also generally long-term agreements. Customers are charged based on a percentage of assets under management for licensed products, per the agreement, on a monthly or quarterly basis. These revenues are recorded on a monthly or quarterly basis over the term of the license agreement.

Regulatory Fees

Regulatory fees represent fees to fund NASD's member regulatory activities, including the supervision and regulation of members through examinations, financial monitoring, policy, rulemaking, interpretive and enforcement activities. Regulatory fees are recorded net of any member rebates. Regulatory fees include a trading activity fee, gross income assessment, personnel assessment and branch office assessment. The trading activity fee is assessed on the sell side of all member transactions in all covered securities regardless of where the trade is executed, and is assessed directly to the firm responsible for clearing the transaction on behalf of the member firm. The trading activity fee is self-reported to NASD by the firm and recognized as the transaction occurs. Due to the trading activity fee being a self-reported revenue stream for NASD, subsequent adjustments by firms of its trading activity fee obligation may occur and are recognized as an adjustment to revenue in the period the adjustment becomes known to NASD. Gross income assessments, personnel assessments and branch office assessments represent annual fees charged to member firms and representatives and are recognized ratably over the annual period to which they relate.

User Fees

User fees consist of fees charged for initial and annual registrations, qualification exams, fees associated with NASD-sponsored meetings and conferences, processing of membership applications and charges related to the review of advertisements and corporate filings. Registration fees include both an initial and annual fee charged to all NASD-registered representatives. The initial fee is recognized over the estimated customer relationship period and the annual fee over the related annual period. Qualification fees consist of examination and continuing education fees. Qualification fees are recognized as exams or continuing education programs are administered. Advertising represents fees charged for the review of NASD member firms' communications to ensure that they are fair, balanced and not misleading. Advertising fees are recognized as revenue as the review is completed. Corporate financing consists of fees charged by NASD for reviewing proposed public offerings and are recognized as the review is completed.

Dispute Resolution Fees

Dispute resolution fees consist of fees earned during the arbitration and mediation processes. Fees on open cases are recognized as revenue over the average life of a case. Upon the closing of a case, a final billing is prepared and any unpaid fees are recognized as revenue at that time. Dispute resolution fees also include mediation fees, SRO annual fees, neutral training fees and other fees totaling $2.1 million for both years ended December 31, 2005 and 2004. SRO annual fees relate to the maintenance of dispute resolution services including arbitration and mediation, for SROs. Neutral training fees relate to NASD Dispute Resolution's comprehensive arbitrator and mediator application and training program. These fees are recognized either when the cash is received or when the service is provided.

Transparency Services

Transparency services represent fees charged through TRACE, OTC Equities and ADF. TRACE represents fees charged on secondary market transactions in eligible fixed income securities reported to NASD, TRACE system-related fees and TRACE market data fees. ADF is a facility for posting quotes and for reporting and comparing trades. The OTC Equities is a regulated quotation service that displays real-time quotes, last-sale prices and volume information in OTC equity securities. Transparency services are recognized as the transactions occur.

Contract Services

Contract services represent amounts charged by NASDR for regulatory services provided under contractual arrangements and are recognized as revenue as the regulatory service is provided.

Activity Assessment

NASD, as an SRO, pays certain fees and assessments to the SEC pursuant to Section 31 of the Securities Exchange Act of 1934. These fees are designed to cover costs incurred by the government in the supervision and regulation of securities markets and securities professionals and are based on a percentage of the total dollar value of securities sold in The NASDAQ Stock Market, the ADF and OTC Equities. NASD remits these fees to the U.S. Treasury semiannually in March and September. In 2004, the SEC adopted new rules under Section 31 and provided SROs additional guidance as to how the SEC charges SROs for these fees. These rules affected NASD's accounting treatment for such fees in its consolidated financial statements.

NASD recovers the cost of the SEC's fees and assessments through an activity assessment billed to securities firms based on the total dollar value of securities sold in The NASDAQ Stock Market and the ADF. The assessments billed to securities firms are recognized when the transactions occur. The activity assessments for transactions on the OTC Equities are self-reported to NASD and recognized as the transactions are reported. Because this is a self-reported revenue stream for NASD, subsequent adjustments by firms of their activity assessment may occur and are recognized as adjustments to revenue in the period the adjustment becomes known to NASD. As a result of the new SEC rule, beginning in 2004, NASD reported the activity assessment on a gross basis within revenues in accordance with EITF No. 99-19. Amounts due to the SEC are reported as a cost of revenue. This change had no impact on consolidated net income.

Fines

Fines represent sanctions for rule violations and commencing in 2004, are recognized upon assessment.

PENSION BENEFITS

The Company provides three non-contributory defined benefit pension plans for the benefit of eligible employees of its subsidiaries. The non-contributory defined benefit plan consists of a funded Employee Retirement Plan and two unfunded Supplemental Executive Retirement Plans. Several statistical and other factors, which attempt to anticipate future events, are used in calculating the expense and liability related to the plans. Key factors include assumptions about the expected rates of return on plan assets and discount rates as determined by the Company, within certain guidelines. The Company considers market conditions, including changes in investment returns and interest rates, in making these assumptions. The Company determines the long-term rate of return based on analysis of historical and projected returns as prepared by the Company's actuary and external investment consultant. The discount rate used in the calculations is tracked to changes in Moody's Aa bond ratings. The Company's Pension Plan Committee approves both the expected long-term rate of return and the discount rate assumptions.

Unrecognized actuarial gains and losses are being recognized over time in accordance with SFAS No. 87, "Employers Accounting for Pensions." Unrecognized actuarial gains and losses arise from several factors, including experience and assumption changes in the obligations, and from the difference between expected returns and actual returns on plan assets.

The actuarial assumptions used by the Company in determining its pension benefits may differ materially from actual results due to changing market conditions and economic conditions, as well as early withdrawals by terminating plan participants. While the Company believes that the assumptions used are appropriate, differences in actual experience or changes in assumptions may materially affect the Company's financial position or results of operations.

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment," which revises SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS No. 123(R) also amended SFAS No. 95, "Statement of Cash Flows." SFAS No. 123(R) requires that new, modified and unvested share-based payment transactions with employees, such as stock options and restricted stock, be recognized in the financial statements based on their fair value and recognized as compensation expense over the vesting period. NASDAQ adopted SFAS No. 123(R) effective January 1, 2006, using the modified prospective transition method, and will recognize share-based compensation cost on a straight-line basis over the requisite service periods of awards. Under the modified prospective method, non-cash compensation expense will be recognized for the portion of outstanding stock option awards granted prior to the adoption of SFAS No. 123(R) for which service has not been rendered, and for any future stock option grants. The pro forma information presented in Note 12, "NASDAQ Stock Compensation, Stock Awards, and Capital Stock," presents the estimated compensation charges under SFAS No. 123(R). NASDAQ's assessment of the estimated compensation charges is affected by its stock price, as well as assumptions regarding a number of complex and subjective variables and related tax impact. These variables include, but are not limited to, NASDAQ's stock price volatility and employee stock option exercise behaviors.

In 2004, the Emerging Issues Task Force issued EITF No. 03-1, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments," to provide detailed guidance on assessing impairment losses on debt and equity investments. In September 2004, the FASB voted unanimously to delay the effective date of EITF No. 03-1. On November 3, 2005, the FASB issued FASB Staff Position FAS (FSP) No. 115-1, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments," revising the guidance in EITF No. 03-1. FSP No. 115-1 is effective on January 1, 2006. The Company is currently evaluating the impact of FSP No. 115-1 on its consolidated financial statements. The disclosures required by EITF No. 03-1 are included in Note 7, "Investments," to the consolidated financial statements.

Management Report on Internal Control Over Financial Reporting

NASD management is responsible for the preparation and integrity of the consolidated financial statements appearing in our annual report. The consolidated financial statements were prepared in conformity with U.S. generally accepted accounting principles (GAAP) and include amounts based on management's estimates and judgments. NASD management is also responsible for establishing and maintaining adequate internal control over financial reporting and for the assessment of the effectiveness of internal control over financial reporting. Internal control over financial reporting is a process designed by management to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with GAAP.

NASD maintains a system of internal control that is designed to provide reasonable assurance as to the fair and reliable preparation and presentation of the consolidated financial statements, as well as to safeguard assets from unauthorized use or disposition that could have a material effect on the financial statements. NASD's internal control over financial reporting includes written policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of NASD's assets; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of NASD are being made only in accordance with authorizations of NASD's management and governors; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of NASD's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements due to error or fraud, including the possibility of the circumvention or overriding of controls. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management's assessment of and conclusions on the effectiveness of internal control over financial reporting did not include the internal control of Instinet Group Incorporated, subsequently renamed Norway Acquisition Corp., and its subsidiaries, including INET ECN (the "INET Entities"), which are included in the 2005 consolidated financial statements and in 2005 reflect total assets constituting 26.0 percent (which includes 22.5 percent related to goodwill and intangible assets) and net revenues constituting less than 0.6 percent of the related consolidated totals. We did not assess the effectiveness of internal controls over financial reporting at the INET Entities because NASDAQ did not complete its acquisition of these entities until December 2005.

Under the supervision of the Chief Executive Officer and Chief Financial Officer, NASD's management assessed the effectiveness of NASD's internal control over financial reporting as of December 31, 2005. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control—Integrated Framework*. This evaluation included reviews of the documentation of controls, evaluations of the design effectiveness of controls, tests of the operating effectiveness of controls, and a conclusion on management's evaluation. Based on this assessment, we assert that NASD maintained effective internal control over financial reporting as of December 31, 2005.

NASD's financial statements included in this annual report have been audited by Ernst & Young LLP, an independent registered accounting firm. Ernst & Young LLP has also issued an attestation report on management's assessment of the Company's internal control over financial reporting and on the effectiveness of internal control over financial reporting as of December 31, 2005.

Robert R. Glauber
Chairman and CEO

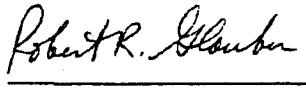
Todd T. Diganci
Executive Vice President and CFO

Certification for 2005 Annual Financial Report

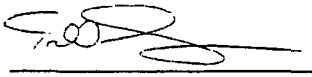
We, Robert R. Glauber and Todd T. Diganci, certify that:

1. We have reviewed this annual financial report of the National Association of Securities Dealers, Inc. (NASD);
2. The purpose of this report is principally to set forth management's report on financial operations with respect to NASD during the year ended December 31, 2005, together with the consolidated financial statements of NASD as of and for the year ended December 31, 2005 and 2004. This report is not intended to comply with the substantive or form requirements for periodic reports under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and the rules and regulations promulgated thereunder (the "Exchange Act Rules and Regulations") required of issuers of securities subject to the periodic reporting requirements under Sections 12, 13 and 15 of the Exchange Act of 1934 and the related Exchange Act Rules and Regulations;
3. Based on our knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
4. Based on our knowledge, the financial statements and other financial information set forth under the caption "Management Report on Financial Operations," fairly present in all material respects the financial condition, results of operations and cash flows of NASD as of, and for, the periods presented in this report;
5. NASD has established disclosure controls and procedures to ensure that material information relating to NASD, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
6. NASD has established internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
7. NASD has carried out its evaluation of the effectiveness of the design and operation of NASD's disclosure controls and procedures as of December 31, 2005. Based upon that evaluation, we have concluded that the disclosure controls and procedures are effective;
8. We have disclosed, based on NASD's most recent evaluation of internal control over financial reporting, to NASD's auditors and the Audit Committee of NASD's Board of Directors:
   a) Any significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting that are reasonably likely to adversely affect NASD's ability to record, process, summarize and report financial information; and
   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in NASD's internal control over financial reporting.

Date: May 11, 2006



Robert R. Glauber
Chairman and CEO



Todd T. Diganci
Executive Vice President and CFO

Audit Committee Report

In accordance with its written Charter adopted by the Board of Governors, the Audit Committee of the Board of Governors assists the Board in fulfilling its responsibility for oversight of the quality and integrity of the accounting, auditing and financial reporting practices of NASD. Each member of the Committee is an independent director as defined by SEC Rule 10A-3 under The Securities Exchange Act of 1934, Listing Standards Relating to Audit Committees. In addition, the Audit Committee and Board of Governors have determined that James E. Burton and Charles A. Bowsher are audit committee financial experts, as defined by the SEC. The Charter gives the Audit Committee responsibility for monitoring the independence of the independent auditors and recommending the appointment of the independent auditors for approval by the Board of Governors, and makes clear that the independent auditors are accountable to the Audit Committee and the Board of Governors, as representatives of the members and the public. In addition, the Charter and the By-laws of NASD make the Director of Internal Audit directly responsible to the Audit Committee. In all respects, the Charter complies with standards applicable to publicly owned companies. (The Charter for the NASD Audit Committee is available at the following URL: *www.nasd.com/auditcommittee_2006*.)

During 2005, the Committee met six times, with the Committee members having a 94 percent attendance rate.

In discharging its oversight responsibility, the Audit Committee reviewed the assessments of audit risk and the audit plans of both the independent and internal auditors. The Audit Committee also discussed with management, the internal auditors and the independent auditors the quality and adequacy of NASD's internal controls and the internal audit organization, responsibilities, budget and staffing.

The Audit Committee obtained a written statement from the independent auditors, Ernst & Young LLP (E&Y), describing all relationships with NASD. The Audit Committee discussed those relationships and satisfied itself that none of the relationships was incompatible with the auditors' independence. The Committee has reviewed and approved all services performed by E&Y for NASD and the associated fees, before initiation of each engagement. We have summarized such services and fees in the following table:

INDEPENDENT REGISTERED PUBLIC ACCOUNTANT (IRPA) FEES

	NASD [4]		NASDAQ [5]		Amex		Total	
	2005	2004	2005	2004	2005	2004	2005	2004
Audit services [1]	$ 1,359,130	$ 646,620	$ 2,935,590	$ 2,307,100	$ –	$ 258,000	$ 4,294,720	$ 3,211,720
Audit-related services [2]	254,152	278,139	622,714	278,314	–	8,456	876,866	564,909
Tax services [3]	37,318	–	36,450	100,000	–	–	73,768	100,000
Total	$ 1,650,600	$ 924,759	$ 3,594,754	$ 2,685,414	$ –	$ 266,456	$ 5,245,354	$ 3,876,629

(1) For 2005, audit services for NASD represent the year-end financial statement audit and the attestation on internal controls under Section 404 of the Sarbanes-Oxley Act of 2002. For 2004, audit services for NASD represent only the year-end financial statement audit. 2005 and 2004 audit services for NASDAQ represent the year-end financial statement audits, attestation procedures in connection with the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act of 2002, reviews of NASDAQ's Form 10-K, and accounting consultations on matters addressed during the audit or interim reviews. For 2004, audit services for Amex include the year-end financial statement audit. In 2005, Amex was no longer part of NASD's consolidated financial statements.

(2) Audit-related services in 2005 and 2004 for NASD reflect fees associated with special purpose audits and agreed-upon procedures, such as IARD, CRD and the employee benefit plans. In 2004, audit-related services for NASD also include consultations associated with the planned disposition of Amex, and consultations related to Section 404 of the Sarbanes-Oxley Act of 2002. NASDAQ audit-related fees represent acquisition due diligence services, the employee benefit plan audit in 2005, and assurance and consultations on NASDAQ's Section 404 internal control program design and employee benefit plan audit in 2004.

(3) Tax services for NASD represent fees related to tax compliance, advice and planning. Tax services for NASDAQ represent preparation of tax returns for expatriate employees.

(4) 2005 and 2004 fees reported for NASD are based on fees approved by NASD's Audit Committee as of March 31, 2006 and March 31, 2005, respectively. The 2005 audit services, audit-related services and tax services include estimates to complete the current work in process. NASD's 2004 fees have been updated from the prior year report to reflect final amounts paid for the 2004 approved services. NASD's IPRA fees for 2004 are less than previously reported due to actual payments made being less than anticipated for services. NASDAQ's fees are presented on a cash basis in accordance with the SEC proxy guidelines.

(5) The NASDAQ Audit Committee separately reviews and approves NASDAQ IRPA services and fees. The NASD Audit Committee has oversight of NASDAQ's Audit Committee, but does not review actions taken with respect to the approval of IRPA fees. NASDAQ fees exclude services provided to non-profit entities of The Nasdaq Stock Market, Inc., services provided in relation to NASDAQ's role as the Securities Information Processor under the Unlisted Trading Privileges Plan and the audit of the NASDAQ-100 Trust, Series 1, and the trust for the NASDAQ-100 Index Tracking Stock, also known as the "QQQ."

NASDAQ also incurred fees to PricewaterhouseCoopers LLP (PwC) for fiscal year ended 2005, totaling $265,187. On December 8, 2005, NASDAQ completed its acquisition of the INET ECN subsidiary. These fees represent audit fees for the INET ECN for the year ended December 31, 2005. The results of the INET ECN have been included in the consolidated NASDAQ results for the period December 8, 2005 through December 31, 2005. PwC was the IRPA for Instinet, including the INET ECN subsidiary prior to the acquisition; and, given their historical knowledge, the NASDAQ Audit Committee chose to continue the relationship through the remainder of 2005.

NASDAQ also incurred fees payable to Deloitte & Touché LLP (Deloitte & Touché) for fiscal year ended 2004, totaling $226,750. On September 7, 2004, NASDAQ completed its acquisition of Toll Associates LLC and affiliated entities, which includes Brut, LLC, from SunGard Data Systems Inc. These fees represent audit fees on the consolidated financial statements of Toll Associates as of December 31, 2004 and for the period September 7, 2004 through December 31, 2004. Deloitte & Touché was the IRPA for Toll Associates prior to the acquisition; and, given their historical knowledge, the NASDAQ Audit Committee chose to continue the relationship through the remainder of 2004.

The Audit Committee discussed and reviewed with the independent auditors all communications required by Statement on Auditing Standard No. 61, *Communications With Audit Committees*. Further, the Committee has reviewed and discussed with management and with E&Y, with and without management present, the audited financial statements as of December 31, 2005, management's assessment of the effectiveness of NASD's internal control over financial reporting, and E&Y's report on the financial statements and on NASD's internal controls over financial reporting. Based on those discussions, the Audit Committee recommended to the Board of Governors that NASD's audited financial statements and related reports on internal control be included in the Annual Report for the year ended December 31, 2005.

Members of the Audit Committee:

James E. Burton, Chair
John W. Bachmann
Charles A. Bowsher
Admiral Tyler F. Dedman
Joel Seligman

May 10, 2006

Report of Independent Registered Public Accounting Firm on Effectiveness of Internal Control Over Financial Reporting

BOARD OF GOVERNORS

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

We have audited management's assessment, included in the accompanying *Management Report on Internal Control over Financial Reporting*, that the National Association of Securities Dealers, Inc. (NASD) maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). NASD's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As indicated in the accompanying *Management Report on Internal Control Over Financial Reporting*, management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of Instinet Group Incorporated, subsequently renamed Norway Acquisition Corp., and its subsidiaries, including INET ECN (the "INET Entities"), which are included in the 2005 consolidated financial statements of NASD and constituted 26.0 percent (which includes 22.5 percent related to goodwill and intangible assets) of the consolidated net assets and less than 0.6 percent of the consolidated net revenues as of December 31, 2005. Management did not assess the effectiveness of internal control over financial reporting at this entity because the Company did not complete its acquisition of these entities until December 2005. Our audit of internal control over financial reporting of NASD also did not include an evaluation of the internal control over financial reporting of Norway and its subsidiaries, including INET ECN.

In our opinion, management's assessment that NASD maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, NASD maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of NASD as of December 31, 2005 and 2004, and the related consolidated statements of income, changes in members' equity, and cash flows for the years then ended of NASD and our report dated May 10, 2006 expressed an unqualified opinion thereon.

Ernst & Young LLP

McLean, Virginia
May 10, 2006

Report of Independent Registered Public Accounting Firm

BOARD OF GOVERNORS

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

We have audited the accompanying consolidated balance sheets of the National Association of Securities Dealers, Inc. (NASD) as of December 31, 2005 and 2004, and the related consolidated statements of income, changes in members' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of NASD at December 31, 2005 and 2004, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of NASD's internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control–Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated May 10, 2006 expressed an unqualified opinion thereon.

Ernst + Young LLP

McLean, Virginia
May 10, 2006

NASD 2005 Consolidated Balance Sheets

(DOLLARS IN THOUSANDS)

	DECEMBER 31, 2005	2004
Assets		
Current assets:		
Cash and cash equivalents	$ 296,057	$ 123,834
Investments:		
Available-for-sale, at fair value	1,924,296	1,381,682
Foundation unrestricted available-for-sale, at fair value	24,059	10,177
Foundation temporarily restricted available-for-sale, at fair value	5,911	–
Held-to-maturity, at amortized cost	–	28,600
Receivables, net	342,309	151,830
Receivables from related parties	18	4,946
Deferred tax assets	9,953	24,209
Other current assets	47,873	21,056
Total current assets	2,650,476	1,746,334
Held-to-maturity investments, at amortized cost	–	2,008
Property and equipment:		
Land, buildings and improvements	154,218	172,350
Data processing equipment and software	348,236	369,239
Furniture, equipment and leasehold improvements	234,279	264,442
	736,733	806,031
Less accumulated depreciation and amortization	(467,365)	(492,186)
Total property and equipment, net	269,368	313,845
Non-current deferred tax assets	133,336	48,765
Revolving credit facility receivable from Amex	18,030	—
Note receivable from Amex	—	25,000
Goodwill	961,893	141,381
Intangible assets, net	217,178	44,260
Other assets	60,257	33,125
Total assets	$ 4,310,538	$ 2,354,718

See accompanying notes.

NASD 2005 Consolidated Balance Sheets

(DOLLARS IN THOUSANDS)

	DECEMBER 31, 2005	2004
Liabilities and members' equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 150,166	$ 65,026
SEC fee payable	157,176	68,275
Accrued personnel and benefit costs	188,481	145,557
Deferred revenue	114,644	137,523
Deposits and renewals	57,740	63,032
Current portion of debt obligations	7,500	–
Due to custodial agent	41,001	17,696
Due to related parties	–	450
Warrants to purchase NASDAQ common stock from NASD	183,180	–
Other current liabilities	69,223	56,681
Total current liabilities	969,111	554,240
Accrued pension and other post retirement benefit costs	49,056	57,794
Long-term debt	1,184,928	265,000
Non-current deferred tax liabilities	95,151	29,514
Deferred revenue	108,794	107,061
Deferred contribution income	53,115	–
Warrants to purchase NASDAQ common stock from NASD	–	3,836
Other liabilities	109,152	64,310
Total liabilities	2,569,307	1,081,755
Minority interest	129,967	11,938
Commitments and contingencies		
Members' equity	1,511,453	1,194,043
Unrealized gain on available-for-sale investments	107,977	74,131
Foreign currency translation	295	988
Minimum pension liability	(8,461)	(8,137)
Total members' equity	1,611,264	1,261,025
Total liabilities and members' equity	$ 4,310,538	$ 2,354,718

See accompanying notes.

NASD 2005 Consolidated Statements of Income

(DOLLARS IN THOUSANDS)

	YEARS ENDED DECEMBER 31, 2005	2004
Revenues		
Operating revenues		
Market services	$ 645,953	$ 332,540
Issuer services	224,525	201,458
Regulatory fees, net of member rebates of $50,000 in 2005 and $30,000 in 2004	185,448	222,844
User fees	145,266	137,277
Dispute resolution fees	72,942	80,181
Transparency services	22,806	14,736
Contract services	22,488	4,693
Other	7,340	2,321
Total operating revenues	1,326,768	996,050
Activity assessment	399,100	230,853
Fines	148,496	114,414
Total revenues	1,874,364	1,341,317
Cost of revenues		
SEC activity remittance	(413,483)	(230,853)
Liquidity rebates	(255,501)	(38,114)
Brokerage, clearance and exchange fees	(85,580)	(17,731)
Total cost of revenues	(754,564)	(286,698)
Net revenues	1,119,800	1,054,619
Expenses		
Compensation and benefits	503,677	454,827
Professional and contract services	172,051	139,182
Computer operations and data communications	86,684	123,443
Depreciation and amortization	104,541	115,867
Occupancy	56,648	59,081
General and administrative	91,769	104,354
Total expenses	1,015,370	996,754
Net revenues less expenses	104,430	57,865
Other income (expense)		
Interest and dividend income	72,717	35,348
Interest expense	(20,359)	(11,773)
Net realized investment gains	20,503	25,684
Gain on sale of NASDAQ common stock	383,838	–
(Loss) gain on NASDAQ warrants	(179,344)	3,909
Loss from equity affiliate	(234)	–
Minority interest in earnings of subsidiaries	(43,264)	(5,149)
Income before income taxes, discontinued operations and cumulative effect of change in accounting principle	338,287	105,884
Provision for income taxes	(44,572)	(749)
Income from continuing operations	293,715	105,135
(Loss) income from discontinued operations (net of tax of $0 in 2005 and $5,596 in 2004)	(318)	19,698
Cumulative effect of change in accounting principle	–	(58,342)
Net income	$ 293,397	$ 66,491
Pro forma net income assuming the accounting change is applied retroactively		$ 124,833

See accompanying notes.

NASD 2005 Consolidated Statements of Changes in Members' Equity

(DOLLARS IN THOUSANDS)

	Members' Equity	Accumulated Other Comprehensive Income (Loss)	Total
Balance, January 1, 2004	$ 1,120,191	$ 36,723	$ 1,156,914
Net income	66,491		66,491
Unrealized gain on available-for-sale investments, net of tax of $599, net of minority interests of ($409)	–	34,689	34,689
Foreign currency translation, net of minority interests of $99	–	113	113
Minimum pension liability, net of tax of $293, net of minority interests of ($201)	–	(4,543)	(4,543)
Comprehensive income	–	–	96,750
Increase in equity attributable to the minority interest in the loss on exchange and accretion of NASDAQ preferred stock	2,191	–	2,191
Increase in equity attributable to the minority interest in preferred stock dividends and distributions to NASD for the NASDAQ insurance agency	3,894	–	3,894
Increase in equity attributable to the issuance of stock by NASDAQ and its subsidiaries, net of minority interest of $1,121	1,154	–	1,154
Increase in equity attributable to amortization of restricted stock awards by NASDAQ, net of minority interest of $100	122	–	122
Balance, December 31, 2004	1,194,043	66,982	1,261,025
Net income	293,397	–	293,397
Unrealized gain on available-for-sale investments, net of tax of ($253), net of minority interests of ($39)	–	33,846	33,846
Foreign currency translation, net of minority interests of $537	–	(693)	(693)
Minimum pension liability, net of tax of $303, net of minority interests of ($1,065)	–	(324)	(324)
Comprehensive income	–	–	326,226
Increase in equity attributable to the minority interest in preferred stock dividends, accretion of preferred stock, and distributions to NASD for the NIA	5,673	–	5,673
Increase in equity attributable to the issuance of stock by NASDAQ and its subsidiaries, net of minority interest of $57,282	17,481	–	17,481
Increase in equity attributable to issuance of warrants by NASDAQ, net of minority interest of $1,870	423	–	423
Increase in equity attributable to amortization of restricted stock awards by NASDAQ, net of minority interest of $922	436	–	436
Balance, December 31, 2005	$ 1,511,453	$ 99,811	$ 1,611,264

See accompanying notes.

NASD 2005 Consolidated Statements of Cash Flows

(DOLLARS IN THOUSANDS)

	YEARS ENDED DECEMBER 31, 2005	2004
Reconciliation of net income to cash provided by operating activities		
Net income	$ 293,397	$ 66,491
Net (loss) income from discontinued operations	(318)	19,698
Income from continuing operations	$ 293,715	$ 46,793
Adjustments to reconcile net income to cash provided by operating activities:		
Cumulative effect of change in accounting principle	–	58,342
Depreciation and amortization	104,541	115,867
Gain on sales of NASDAQ common stock by NASD	(383,838)	–
Loss (gain) on NASDAQ warrants	179,344	(3,909)
Amortization of restricted stock and other stock-based compensation	1,358	541
Net realized gains on investments	(44,277)	(28,773)
Investment impairment charges	23,774	3,089
Loss on assets held-for-sale	–	7,369
Loss on disposal of fixed assets	–	3,664
Asset impairment charges	1,718	1,506
Discount on revolving credit facility receivable from Amex	8,589	–
Charge on restructuring the $240.0 million convertible notes	7,393	–
Deferred taxes	3,469	26,142
Bad debt expense	6,826	7,502
Loss from equity affiliate	234	–
Minority interest in earnings of subsidiaries	43,264	5,149
Contributions and net investment income temporarily restricted	(6,900)	–
Other net non-cash income items	1,807	6,003
Net change in operating assets and liabilities, net of acquisitions and dispositions:		
Receivables, net	(108,076)	35,162
Amounts due from related parties	1,613	(2,885)
Other current assets	(10,802)	1,854
Other assets	(27,452)	1,306
Accounts payable and accrued expenses	35,634	(14,970)
Accrued personnel and benefit costs	34,159	8,504
Deferred revenue	31,939	4,993
Deposits and renewals	(5,292)	(4,188)
SEC fee payable	88,901	(83,923)
Other current liabilities	(11,001)	(61,387)
Accrued pension and other post-retirement costs	(8,738)	11,026
Other liabilities	6,963	9,209
Net cash provided by continuing operations	268,865	153,986
Cash (used in) provided by discontinued operations	(318)	2,178
Net cash provided by operating activities	$ 268,547	$ 156,164

See accompanying notes.

NASD 2005 Consolidated Statements of Cash Flows

(DOLLARS IN THOUSANDS)

	YEARS ENDED DECEMBER 31, 2005	2004
Cash flow from investing activities		
Proceeds from redemptions of available-for-sale investments	$ 3,512,717	$ 4,266,970
Purchases of available-for-sale investments	(4,007,031)	(4,396,417)
Proceeds from maturities and redemptions of held-to-maturity investments	62,702	26,828
Purchases of held-to-maturity investments	(32,009)	(29,058)
Issuance of revolving credit facility to Amex	(25,000)	–
Repayment by Amex of note receivable	25,000	–
Net proceeds from the sale of NASDAQ common stock by NASD	403,537	–
Acquisitions of businesses, net of cash and cash equivalents acquired	(970,467)	(190,000)
Investments in and advances to affiliates	(7,528)	–
Return on capital from investments in affiliates	1,015	–
Purchases of property and equipment	(48,400)	(54,555)
Proceeds from sales of property and equipment	42	11,299
Net cash used in investing activities	(1,085,422)	(364,933)
Cash flow from financing activities		
Proceeds from issuances of debt obligations	955,000	–
Redemption of senior notes	(25,000)	–
Net proceeds from the issuance of NASDAQ common stock by NASDAQ	52,930	2,273
Temporarily restricted contributions to the Foundation	6,900	–
Payments for treasury stock purchases by NASDAQ	(73)	(85)
Principal payments on capital leases	(659)	(2,369)
Net cash provided by (used in) financing activities	989,098	(181)
Increase (decrease) in cash and cash equivalents	172,223	(208,950)
Cash and cash equivalents at beginning of year	123,834	332,784
Cash and cash equivalents at end of year	$ 296,057	$ 123,834
SUPPLEMENTAL DISCLOSURES:		
Cash payments for interest	$ 15,727	$ 11,772
Cash payments (refunds) of taxes, net	$ 37,061	$ (49,986)

See accompanying notes.

NASD 2005 Notes to Consolidated Financial Statements

1. ORGANIZATION AND NATURE OF OPERATIONS

NASD

The National Association of Securities Dealers, Inc. (NASD), a Delaware corporation, is the controlling owner of The Nasdaq Stock Market, Inc. (NASDAQ) by virtue of the Series D Preferred Stock, and wholly owns the following significant subsidiaries: NASD Regulation, Inc. (NASDR), NASD Dispute Resolution, Inc. (NASD DR), New NASD Holding, Inc. (NASD Holding), and NASD Investor Education Foundation (the Foundation); collectively referred to as the Company.

NASD regulates the activities of the U.S. securities industry and regulates NASDAQ, The American Stock Exchange LLC (Amex), and the over-the-counter (OTC) securities markets. NASDR carries out NASD's regulatory functions, including onsite examinations of securities firms, continuous automated surveillance of markets operated by NASDAQ and Amex, and disciplinary actions against firms and registered representatives. NASD DR provides arbitration and mediation services to assist in the resolution of monetary and business disputes between and among investors, securities firms and registered representatives.

On January 13, 2006, the SEC approved NASDAQ's application to operate as a national securities exchange (Exchange Registration). NASDAQ will begin operating as an exchange once it meets conditions imposed by the SEC. Upon effectiveness of Exchange Registration, NASDAQ will redeem the Series D Preferred Stock and NASD will no longer have voting control over NASDAQ and will cease consolidating NASDAQ and will have reduced its ownership of NASDAQ to the number of shares underlying the unexercised warrants for Tranche IV. See Note 3, "NASDAQ Restructuring" for additional information.

NASD INVESTOR EDUCATION FOUNDATION

On February 13, 2004, NASD established the Foundation, a non-profit membership organization incorporated in Delaware. The Foundation provides investors with high quality, easily accessible information and tools to better understand investing and the markets. The Foundation awards grants to fund educational programs and research aimed at segments of the investing public who could benefit from additional resources. NASD is the sole member of the Foundation.

NASD HOLDING

NASD Holding owned the Class B interest in The American Stock Exchange, LLC (Amex) until December 31, 2004, when it sold the Class B interest in Amex to Amex Membership Corporation. See Note 15, "Discontinued Operations," for additional information.

NASDAQ

NASDAQ is a leading provider of securities listing, trading and information products and services. NASDAQ operates The NASDAQ Stock Market, the largest electronic equity securities market in the U.S., both in terms of number of listed companies and traded share volume.

On December 8, 2005, NASDAQ completed the acquisition of Instinet Group Incorporated (Instinet), subsequently renamed Norway Acquisition Corp. (Norway), and the immediate sale of Instinet's Institutional Brokerage division to an affiliate of Silver Lake Partners, an unaffiliated private equity firm. As a result of these transactions NASDAQ owns Norway. Norway owns 100.0 percent of INET Holding Company, Inc. (IHC). IHC owns 100.0 percent of INET ATS, Inc. (INET), an electronic communication network and Island Execution Services, LLC, which are broker-dealers registered pursuant to the Securities Exchange Act of 1934.

NASD 2005 Notes to Consolidated Financial Statements

1. ORGANIZATION AND NATURE OF OPERATIONS (CONTINUED)

On October 1, 2005, NASDAQ completed the acquisition of Carpenter Moore Insurance Services, Inc. (Carpenter Moore), a privately held, San Francisco-based insurance brokerage firm specializing in management liability. Carpenter Moore is a wholly owned subsidiary of NASDAQ Insurance Agency.

On June 7, 2005, NASDAQ and Reuters announced the formation of the Independent Research Network (IRN), a new joint venture created to help public companies obtain independent analyst coverage. The IRN began operations in the third quarter of 2005.

On January 1, 2005, NASDAQ purchased the remaining 50.0 percent interest in the NASDAQ Insurance Agency from AIG NJV, Inc. for nominal consideration.

On September 7, 2004, NASDAQ completed its acquisition of Toll Associates LLC (Toll) and affiliated entities from SunGard Data Systems Inc. Toll is a holding company that owns a 99.8 percent interest in Brut, LLC, the owner and operator of the Brut ECN, a broker-dealer registered under the Securities Exchange Act of 1934. Toll also holds a 100.0 percent interest in Brut Inc., which owns the remaining 0.2 percent interest in Brut and serves as its manager under an operating agreement. As of December 31, 2005, Brut also owned Brut Europe Limited as a wholly owned subsidiary. NASDAQ determined to dissolve Brut Europe Limited and it was placed into members' voluntary liquidation on July 27, 2005. NASDAQ expects Brut Europe Limited to be completely dissolved by the end of the first quarter of 2006.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of NASD and its wholly owned and majority owned subsidiaries. Investments for which the Company has the ability to exercise significant influence, but not control, are accounted for using the equity method. All significant intercompany balances and transactions have been eliminated in consolidation.

USE OF ESTIMATES

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

SEGMENTS

The Company operates in two primary business segments, NASD and NASDAQ, as defined by Statement of Financial Accounting Standards (SFAS) No. 131, "Disclosures About Segments of an Enterprise and Related Information." NASD's chief operating decision maker, as defined by SFAS No. 131, is its Chief Executive Officer. The Company uses net revenue less expenses to evaluate performance of its business segments.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents include demand cash and all non-restricted investments purchased with a remaining maturity of three months or less at the time of purchase.

NASD 2005 Notes to Consolidated Financial Statements

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

INVESTMENTS

Under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," management determines the appropriate classification of investments at the time of purchase. Investments for which the Company does not have the intent or ability to hold to maturity are classified as available-for-sale and are carried at fair value, with any unrealized gains and losses, net of tax, reported as a separate component of members' equity. Investments for which the Company has the intent and ability to hold to maturity are classified as held-to-maturity and are carried at amortized cost. The amortized cost of debt securities classified as held-to-maturity is adjusted for amortization of premiums and accretion of discounts. Fair value is determined based on quoted market prices when available, or if quoted market prices are not available, on discounted expected cash flows using market rates commensurate with the credit quality and maturity of the investment. Realized gains and losses on sales of securities are included in earnings using the average cost method. Amounts due to or from the custodial agent relate to security trades executed prior to the balance sheet date but not yet settled.

Available-for-sale investments also include investments in auction rate securities, which are either preferred stock or bonds with interest rates that reset periodically, typically less than every 90 days, based on a Dutch auction process. Given the longer-term maturities of these securities, they are classified as available-for-sale investments, rather than cash and cash equivalents.

The Company regularly monitors and evaluates the realizable value of its securities portfolio. When assessing for other-than-temporary declines in value, the Company considers such factors as the extent of the decline in value, the duration for which the market value had been less than cost, the performance of the investee's stock price in relation to the stock price of its competitors within the industry and the market in general, any news that has been released specific to the investee and the outlook for the overall industry in which the investee operates. The Company also reviews the financial statements of the investee to determine if the investee is experiencing financial difficulties. If events and circumstances indicate that a decline in the value of these assets has occurred and is deemed other-than-temporary, the carrying value of the security is reduced to its fair value and the impairment is charged to earnings.

DERIVATIVE INSTRUMENTS

The Company accounts for freestanding and embedded derivative instruments in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities." SFAS No. 133, as amended and interpreted, establishes accounting and reporting standards for derivative instruments and requires that all derivatives be recorded on the balance sheet at fair value. Additionally, the accounting for changes in fair value depends on whether the derivative instrument is designated and qualifies as part of a hedging relationship and, if so, the nature of the hedging activity. Changes in the fair value of derivatives that do not qualify for hedge treatment are recognized currently in earnings. NASD's derivative instruments are not part of a hedging relationship; therefore, changes in market value are recorded in earnings.

NASD invests in derivative instruments in accordance with its investment policy. The goal of NASD's investment policy is to generate long-term returns to support NASD operations for the benefit of investors and members, to preserve the real purchasing power of those funds for future contingencies, and to maintain financial balance sheet strength. To this end, the portfolio includes absolute return-oriented investments, the goals of which are to post a positive return in both strong and weak market environments, and particularly to protect capital in down market environments. As of December 31, 2005 and 2004, the Company

NASD 2005 Notes to Consolidated Financial Statements

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

had investments in written options, futures contracts, forward contracts and swaps; the fair value of these derivative instruments was insignificant.

RECEIVABLES, NET

The Company's receivables are primarily concentrated with NASD members, market data vendors and NASDAQ-listed companies. Receivables are shown net of reserves for uncollectible accounts. Reserves are calculated based on the age and source of the underlying receivable and are tied to past collections experience. The reserve for bad debts is maintained at a level that management believes to be sufficient to absorb estimated losses in the accounts receivable portfolio. The reserve is increased by the provision for bad debts, which is charged against operating results and decreased by the amount of charge-offs, net of recoveries. The amount charged against operating results is based on several factors, including a continuous assessment of the collectibility of each account. In circumstances where a specific customer's inability to meet its financial obligations is known (i.e., bankruptcy filings), the Company records a specific provision for bad debts against amounts due to reduce the receivable to the amount the Company reasonably believes will be collected. For all other customers, provisions for bad debts are made based on the length of time the receivable is past due and historical experience. For receivables past due 31-60 days, 61-90 days, and over 90 days, the outstanding account balances are reserved for between 0.0 and 10.0 percent, 10.0 to 50.0 percent, and 50.0 to 100.0 percent of the outstanding account balances, respectively. If circumstances change (e.g., higher than expected defaults or an unexpected material adverse change in a major customer's ability to pay), the Company estimates of recoverability could be reduced by a material amount. Total reserves netted against receivables in the consolidated balance sheets were $12.5 million and $8.3 million at December 31, 2005 and 2004, respectively.

RELATED PARTY TRANSACTIONS

Related party receivables and payables are the result of various transactions between the Company and its affiliates. Related party receivables and payables, as of December 31, 2004, also include transactions with Amex. As of December 31, 2005, amounts due from Amex were included within accounts receivable, net, in the consolidated balance sheet, as Amex is no longer a related party.

DEPOSIT ASSETS

Other current assets include $4.2 million and $2.0 million of deposits as of December 31, 2005 and 2004, respectively. These deposits, which are held at clearing organizations and clearing brokers, are for Brut and INET and serve primarily for clearance and settlement services.

PROPERTY AND EQUIPMENT

Property and equipment are recorded at cost less accumulated depreciation. Equipment acquired under capital leases is initially recorded at the lower of fair value or the present value of future lease payments. Repairs and maintenance costs are expensed as incurred. Depreciation and amortization are calculated using the straight-line method over estimated useful lives ranging from 10 years to 40 years for buildings and improvements, two years to seven years for data processing equipment and software, and five years to 10 years for furniture and equipment. Leasehold improvements are amortized using the straight-line method over the lesser of the useful life of the improvement or the term of the applicable lease. Depreciation and amortization expense for property and equipment, including amortization of capitalized software costs, totaled $91.2 million and $106.5 million for the years ended December 31, 2005 and 2004, respectively.

NASD 2005 Notes to Consolidated Financial Statements

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Property and equipment includes capital leases of $2.5 million and $2.4 million and accumulated amortization of $1.5 million and $0.7 million for the years ended December 31, 2005 and 2004, respectively. Amortization of assets under capital lease was $0.8 million and $3.6 million for the years ended December 31, 2005 and 2004, respectively, and is included within depreciation and amortization expense in the consolidated statements of income.

As of December 31, 2005, property and equipment, net, included an asset "held-for-sale" with a carrying value of $6.7 million, related to an owned building (Diamondback) in Rockville, Maryland. In November 2005, NASD executed an agreement to sell this building to a third party, which is expected to close in the summer of 2006.

As of December 31, 2004, property and equipment, net, included an asset "held-for-sale" with a carrying value of $17.6 million, related to an owned building (Key West) in Rockville, Maryland. The carrying value for this building was determined based on the fair value of $18.0 million less estimated costs to sell of $0.4 million. In June 2005, NASDAQ completed the sale of the building to NASD for $18.0 million, and the building was re-categorized as "held and used" in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

SOFTWARE COSTS

Significant purchased application software, and operational software that is an integral part of computer hardware, are capitalized and amortized using the straight-line method over their estimated useful lives, generally two to seven years. All other purchased software is charged to expense as incurred. In accordance with AICPA Statement of Position (SOP) No. 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," the Company capitalizes internal computer software development costs incurred during the application development stage. Computer software costs incurred prior to or subsequent to the application development stage are charged to expense as incurred.

Unamortized, capitalized software development costs of $60.2 million and $85.2 million as of December 31, 2005 and 2004, respectively, are classified within data processing equipment and software in the consolidated balance sheets. Amortization of costs capitalized under SOP No. 98-1 totaled $43.1 million and $31.4 million for 2005 and 2004, respectively, and is included in depreciation and amortization in the consolidated statements of income. Additions to capitalized software were $18.1 million and $16.4 million in 2005 and 2004, respectively.

SFAS No. 34, "Capitalization of Interest Cost," requires the capitalization of interest as part of the historical cost of acquiring assets, for all costs incurred to prepare the assets for their internal use. SOP No. 98-1 includes interest costs incurred while developing internal-use software as capitalizable costs under SFAS No. 34. The effect of capitalization of interest cost related to the development of internal-use software is not material when compared with the effect of expensing these interest costs as incurred. Therefore, all interest costs have been expensed when incurred.

GOODWILL AND INTANGIBLE ASSETS, NET

The Company accounts for its goodwill and intangible assets in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets." Goodwill represents the excess of purchase price and related costs over the value assigned to the net tangible and identifiable intangible assets of a business acquired. Goodwill is tested for impairment at the reporting unit level annually, or in interim periods if certain events occur indicating that the carrying value may be impaired. If the fair value of the reporting unit is less than its carrying value, an impairment loss is recorded to the extent that the fair value of the goodwill is less than the carrying

NASD 2005 Notes to Consolidated Financial Statements

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

value. The fair value of goodwill is determined based on discounted cash flows. The Company completed the required annual impairment test, which resulted in no impairment of goodwill in 2005.

Intangible assets, net, which include technology and customer relationships, are amortized on a straight-line basis over their estimated average useful lives, ranging from one year to 20 years. Upon the adoption of SFAS No. 142, intangible assets deemed to have indefinite useful lives are not amortized and are subject to annual impairment tests. Impairment exists if the carrying value of the indefinite-lived intangible asset exceeds its fair value. For finite-lived intangible assets subject to amortization, impairment is considered upon certain "triggering events" and is recognized if the carrying amount is not recoverable and the carrying amount exceeds the fair value of the intangible asset.

NASD had license agreements of $6.7 million and $7.5 million with accumulated amortization of $5.1 million and $4.3 million as of December 31, 2005 and 2004, respectively. Licenses are amortized over a five-year estimated useful life. Amortization expense for the next three years commencing in 2006 is expected to be $1.1 million, $0.5 million, and $0.04 million, respectively. NASD had a Supplemental Executive Retirement Plan (SERP) pension asset of $0.1 million and $0.3 million as of December 31, 2005 and 2004, respectively. Pension intangible assets were recorded as required by SFAS No. 87. Amounts are not amortized but are adjusted as part of the annual minimum pension liability assessment.

NASDAQ had net intangible assets of $215.5 million and $40.8 million as of December 31, 2005 and 2004, respectively. See Note 4, "NASDAQ Business Combinations," for additional information.

IMPAIRMENT OF LONG-LIVED ASSETS

The Company reviews its long-lived assets for impairment in accordance with SFAS No. 144. In the event facts and circumstances indicate that long-lived assets or other assets may be impaired, an evaluation of recoverability would be performed. If an evaluation were required, the estimated future undiscounted cash flows associated with the asset would be compared to the asset's carrying amount to determine if a write-down is required. If the evaluation indicated impairment, the Company would prepare a discounted cash flow analysis to determine the amount of the impairment.

NASDAQ recorded write-downs for property and equipment of $7.4 million related to long-lived assets held-for-sale in the fourth quarter of 2004, related to an owned building. This charge is included in general and administrative expense in the consolidated statements of income.

INVESTMENTS IN AND ADVANCES TO AFFILIATES

NASD is a limited partner in several private equity funds. Investments in these funds are accounted for using either the cost or equity method. This accounting treatment is in accordance with Emerging Issues Task Force (EITF) No. D-46, "Accounting for Limited Partnership Investments," which states that the SEC staff's current position is that investments in limited partnerships should be accounted for pursuant to SOP No. 78-9, "Accounting for Investments in Real Estate Ventures." As of December 31, 2005, the Company had an investment of $4.2 million in a limited partnership, which is accounted for under the equity method, and $2.4 million of investments in six limited partnerships that are accounted for under the cost method. These investments are included in other assets in the consolidated balance sheets. The company has total outstanding commitments of $69.7 million to these partnerships.

NASD 2005 Notes to Consolidated Financial Statements

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

NOTE RECEIVABLE AND REVOLVING CREDIT FACILITY RECEIVABLE FROM AMEX

On December 31, 2004, NASD and Amex entered into an Amended and Restated Loan Agreement (New Note), which amended Amex's previous borrowings from NASD from $50.0 million to a $25.0 million note. The New Note had a scheduled maturity of October 31, 2011 and bore interest at a rate of 10.0 percent per annum (non-compounding) until December 31, 2005, and 5.0 percent per annum thereafter. In August 2005, Amex repaid this note in full, plus accrued interest of $1.6 million. This income is included within interest and dividend income in the consolidated statements of income.

On December 31, 2004, NASD and Amex entered into a revolving credit facility, pursuant to which Amex has the ability to borrow from NASD additional amounts, up to a maximum, at any one time, of $25.0 million at an interest rate of 5.0 percent. The maturity date for the revolving credit facility is October 31, 2011. In February 2005, Amex borrowed $25.0 million under the revolving credit facility, and NASD recorded a discount of $8.6 million, representing the difference between the stated rate of interest and the estimated market rate of 11.2 percent. This discount was recorded in general and administrative expenses in the consolidated statements of income. Interest is recognized using the effective interest method. For the year ended December 31, 2005, interest income was $1.6 million and is included within interest and dividend income in the consolidated statements of income.

DEFERRED REVENUE

Deferred revenue represents cash received and billed receivables for which services have not yet been provided. Included in deferred revenue are the unearned portion of registration fees, arbitration fees, member application fees, initial listing fees (IL) and listing of additional shares fees (LAS). The Company recognizes revenue from the upfront initial components of these fees on a straight-line basis over estimated customer relationship periods, determined based on historical experience, ranging from 15 months to 10 years. The estimated service periods for IL fees are six years, while LAS fees are recognized over a four-year service period. The Company recognizes revenue from the annual component of these fees over the annual contract period.

DEFERRED CONTRIBUTION INCOME

On September 2, 2005, the Federal District Court for the Southern District of New York issued an order approving the SEC's new investor education plan, whereby all funds collected in connection with the Global Research Analyst Settlement (the Settlement) will be remitted to the Foundation. Pursuant to the final judgments against each of the defendants under the Settlement, the SEC was to collect a total of $55.0 million in equal annual installments of $11.0 million beginning in October 2003.

Upon the issuance of the order, the Foundation recorded a contribution receivable and contribution revenues of approximately $52.3 million, representing the net present value of all payments to be received. For the year ended December 31, 2005, the Foundation recognized contribution revenue of $0.8 million, representing accretion income on the receivable. As of December 31, 2005, the total contribution receivable is $53.1 million, of which $43.7 million is recorded as a current asset in accounts receivable, net in the consolidated balance sheets. The remaining $9.4 million relates to the final annual installment due in October 2007, and is recorded as a non-current asset in other assets in the consolidated balance sheets.

As mentioned in Note 1, the Foundation is a consolidated subsidiary of NASD. On a consolidated basis, the $53.1 million has been recorded as deferred contribution income in the accompanying financial statements and will be recognized as revenue as the Foundation administers grant payments pursuant to the guidelines of its grant program. As of December 31, 2005, no amounts were received by the Foundation related to the Settlement and no grant payments were incurred by the Foundation related to this contribution.

NASD 2005 Notes to Consolidated Financial Statements

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Under the Settlement, the Foundation must invest funds received in money market funds or securities with maturities of less than six months and backed by the full faith and credit of the federal government. Amounts received in relation to this order will be reported by the Foundation as unrestricted. In the event of a proposed dissolution of the Foundation, the SEC shall file an application with the Court setting forth a plan for the disposition of any remaining funds in the Foundation.

DEPOSIT AND RENEWAL LIABILITIES

NASD-registered firms make deposits into NASD's Central Registration Depository (CRD) system to pay for services including registration fees charged by states and other SROs. Total CRD-related deposits were $55.0 million and $48.9 million as of December 31, 2005 and 2004, respectively.

In July 2004, NASD agreed to administer the monies of a restitution fund collected for defrauded victims of A.S. Goldmen pursuant to an Order of Restitution issued by the Supreme Court of the State of New York. Total deposits related to this restitution fund were $11.7 million as of December 31, 2004. As of December 31, 2005, $0.5 million remained to be distributed to the appropriate parties. The corresponding funds are included in cash and cash equivalents as of December 31, 2005 and 2004.

OTHER LIABILITIES

NASD's other liabilities include amounts associated with the Investment Advisers Registration Depository (IARD) Program and the Continuing Education (CE) Program.

Investment Advisers Registration Depository Program

NASDR administers the IARD program. IARD is an electronic filing system for investment advisers regulated by the SEC under the Investment Advisers Act of 1940, and by the states, represented by the North American Securities Administrators Association. The IARD system collects and maintains the registration and disclosure information for investment advisers and their associated persons. As administrator of the IARD program, NASDR collects all fees and incurs expenses, which are tracked and reported to the SEC on a quarterly basis. In accordance with the Memorandum of Understanding (MOU) with the SEC, signed on July 24, 2001, the distribution of the cumulative cash basis surplus attributable to filings by SEC-registered investment advisers upon termination of the MOU, will be determined by the SEC for the benefit of IARD filers. NASDR has applied the same principles of the MOU with the SEC to the cumulative surplus attributable to filings by state-registered investment advisers.

As of December 31, 2005 and 2004, the cumulative cash basis surplus for the IARD program was $27.1 million and $24.6 million, respectively, which was recorded in NASD's consolidated financial statements as follows:

	DECEMBER 31,	
	2005	2004
	(in thousands)	
Current deferred revenue	$ 1,610	$ 11,121
Non-current deferred revenue	2,605	2,478
Other liabilities	22,915	11,003
Total	$ 27,130	$ 24,602

NASD 2005 Notes to Consolidated Financial Statements

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Continuing Education Program

NASDR, in conjunction with NYSE and the Securities Industry/Regulatory Council on Continuing Education (the Council), administers a two-part mandatory CE program. The CE program requires all registered persons to take a computer-based program on the second anniversary of their initial securities registration and every three years thereafter, and for broker-dealers to provide on-going training, tailored specifically to the products and services they provide. Compliance with CE program requirements is evaluated as part of the on-site examinations that are conducted by the SROs. As administrator of the CE program, NASDR collects all fees and incurs expenses, which are tracked and reported to the Council on a quarterly basis. In accordance with the CE program agreement with the NYSE and the Council, signed on June 9, 1995, the pro-rata cumulative excess of income over expenses attributable to the CE program is due back to each party upon termination of the agreement. As of December 31, 2005 and 2004, NASDR has established a reserve for the NYSE's portion of the cumulative surplus for the CE program of $2.7 million and $3.5 million, respectively, representing the cumulative income over expenses for the program attributable to NYSE. This reserve is included within other liabilities in the consolidated balance sheets.

WARRANTS TO PURCHASE NASDAQ COMMON STOCK FROM NASD

In 2000 and 2001, NASD issued 10.8 million warrants for the purchase of 43.2 million shares of NASDAQ common stock. NASD accounts for these warrants in accordance with EITF No. 00-6, "Accounting for Freestanding Derivative Instruments Indexed to, and Potentially Settled in, the Stock of a Consolidated Subsidiary." These warrants are carried at fair value with changes in the fair value recorded in income, which resulted in a (loss) gain of ($179.3) million and $3.9 million for the years ended December 31, 2005 and 2004, respectively. As of December 31, 2005, the fair value of the warrants is reported within current liabilities, as the exercise period for the outstanding warrants expires in June 2006. NASD obtained a third-party valuation to determine the fair value of these warrants as of December 31, 2005. As of December 31, 2004, NASD determined the fair value using a Black-Scholes valuation model using the following assumptions: a weighted-average expected life of 1.4 years, a weighted-average expected volatility of 30.0 percent and a weighted-average risk free interest rate of 3.06 percent.

REVENUE RECOGNITION AND COST OF REVENUE

Market Services

Market services revenues are derived from NASDAQ Market Center and NASDAQ Market Services Subscriptions revenues. NASDAQ Market Center revenues are variable, based on service volumes, and recognized as transactions occur. NASDAQ Market Services Subscriptions revenues are based on the number of presentation devices in service and quotes delivered through those devices. NASDAQ Market Services Subscriptions revenues are recognized in the month that information is provided. These revenues are recorded net of amounts due under revenue-sharing arrangements with market participants. Pursuant to EITF No. 99-19, "Reporting Revenue Gross as Principal vs. Net as an Agent," NASDAQ records execution revenues from transactions executed through Brut and INET on a gross basis in revenues and records expenses such as liquidity rebate payments as cost of revenues as both Brut and INET act as principal. Before the second quarter of 2005, NASDAQ reported other execution revenues net of liquidity rebates since NASDAQ does not act as principal.

Issuer Services

Issuer services revenues include annual fees, IL fees and LAS fees. Annual fees are recognized ratably over the following 12-month period. IL and LAS fees are recognized on a straight-line basis over estimated service periods of six and four years, respectively,

NASD 2005 Notes to Consolidated Financial Statements

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

based on historical listing experience. Issuer services also include commission income from NASDAQ Insurance Agency. Commission income is recognized when coverage becomes effective, the premium due under the policy is known or can be reasonably estimated, and substantially all required services related to placing the insurance have been provided. The effect on income of subsequent premium adjustments, including policy cancellations, is recorded when the adjustment is known. Fee income for services other than placement of insurance coverage is recognized as those services are provided. Broker commission adjustments and commissions on premiums billed directly by underwriters are recognized when such amounts can be reasonably estimated.

NASDAQ receives license fees for its trademark licenses related to the NASDAQ-100 Index Tracking Stock (QQQQ) and other financial products linked to NASDAQ indexes issued in the U.S. and abroad. NASDAQ primarily has two types of license agreements: transaction-based licenses and asset-based licenses. Transaction-based licenses are generally renewable long-term agreements. Customers are charged based on transaction volume, a minimum contract amount, or both. If a customer is charged based on transaction volume, NASDAQ recognizes revenue when the transactions occur. If a customer is charged based on a minimum contract amount, NASDAQ recognizes revenue on a pro-rata basis over the licensing term. Asset-based licenses are also generally long-term agreements. Customers are charged based on a percentage of assets under management for licensed products, per the agreement, on a monthly or quarterly basis. These revenues are recorded on a monthly or quarterly basis over the term of the license agreement.

Regulatory Fees

Regulatory fees represent fees to fund NASD's member regulatory activities, including the supervision and regulation of members through examinations, financial monitoring, policy, rulemaking, interpretive and enforcement activities. Regulatory fees are recorded net of any member rebates. Regulatory fees include a trading activity fee, gross income assessment, personnel assessment and branch office assessment. The trading activity fee is assessed on the sell side of all member transactions in all covered securities regardless of where the trade is executed and is assessed directly to the firm responsible for clearing the transaction on behalf of the member firm. The trading activity fee is self-reported to NASD by the firm and recognized as the transaction occurs. Due to the trading activity fee being a self-reported revenue stream for NASD, subsequent adjustments by firms of its trading activity fee obligation may occur and are recognized as an adjustment to revenue in the period the adjustment becomes known to NASD. Gross income assessments, personnel assessments and branch office assessments represent annual fees charged to member firms and representatives and are recognized ratably over the annual period to which they relate.

User Fees

User fees consist of fees charged for initial and annual registrations, qualification exams, fees associated with NASD-sponsored meetings and conferences, processing of membership applications and charges related to the review of advertisements and corporate filings. Registration fees include both an initial and annual fee charged to all NASD-registered representatives. The initial fee is recognized over the estimated customer relationship period and the annual fee over the related annual period. Qualification fees consist of examination and continuing education fees. Qualification fees are recognized as exams or continuing education programs are administered. Advertising represents fees charged for the review of NASD member firms' communications to ensure that they are fair, balanced and not misleading. Advertising fees are recognized as revenue as the review is completed. Corporate financing consists of fees charged by NASD for reviewing proposed public offerings and are recognized as the review is completed.

NASD 2005 Notes to Consolidated Financial Statements

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Dispute Resolution Fees

Dispute resolution fees consist of fees earned during the arbitration and mediation processes. Fees on open cases are recognized as revenue over the average life of a case. Upon the closing of a case, a final billing is prepared and any unpaid fees are recognized as revenue at that time. Dispute resolution fees also include mediation fees, SRO annual fees, neutral training fees and other fees totaling $2.1 million for both years ended December 31, 2005 and 2004. SRO annual fees relate to the maintenance of dispute resolution services including arbitration and mediation, for SROs. Neutral training fees relate to NASD Dispute Resolution's comprehensive arbitrator and mediator application and training program. These fees are recognized either when the cash is received or when the service is provided.

Transparency Services

Transparency services represent fees charged through the Trade Reporting and Compliance Engine (TRACE), OTC Bulletin Board (OTCBB) and other OTC Equities, including the pink sheets, (together "OTC Equities"), and the Alternative Display Facility (ADF). TRACE represents fees charged on secondary market transactions in eligible fixed income securities reported to NASD, TRACE system-related fees and TRACE market data fees. ADF is a facility for posting quotes and for reporting and comparing trades. The OTC Equities is a regulated quotation service that displays real-time quotes, last-sale prices and volume information in OTC equity securities. Transparency services are recognized as the transactions occur.

Contract Services

Contract services represent amounts charged by NASDR for regulatory services provided under contractual arrangements and are recognized as revenue as the regulatory service is provided.

Activity Assessment

NASD, as an SRO, pays certain fees and assessments to the SEC pursuant to Section 31 of the Securities Exchange Act of 1934. These fees are designed to cover costs incurred by the government in the supervision and regulation of securities markets and securities professionals and are based on a percentage of the total dollar value of securities sold in The NASDAQ Stock Market, the ADF and the OTC Equities. NASD remits these fees to the U.S. Treasury semiannually in March and September.

NASD recovers the cost of the SEC's fees and assessments through an activity assessment billed to securities firms based on the total dollar value of securities sold in The NASDAQ Stock Market and the ADF. The assessments billed to securities firms are recognized when the transactions are reported. The activity assessments for transactions on the OTC Equities are self-reported to NASD and recognized as the transactions occur. Due to this being a self-reported revenue stream for NASD, subsequent adjustments by firms of its activity assessment may occur and are recognized as an adjustment to revenue in the period the adjustment becomes known to NASD. NASD reports the activity assessment on a gross basis within revenues in accordance with EITF No. 99-19. Amounts due to the SEC are reported as a cost of revenue.

Fines

Fines represent sanctions for rule violations and commencing in 2004, are recognized upon assessment. Regarding the use of fines, NASD has a process in place designed to guard against potential conflicts in the organization's collection and use of fines. NASD's fines guidelines provide that: (1) all fine monies are collected and segregated from NASD revenues into a separate account, (2) fine

NASD 2005 Notes to Consolidated Financial Statements

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

monies collected or anticipated are not included in NASD operating revenues and play no role in developing its operating budget, (3) fine monies are not used to fund employee compensation, (4) the use of fine monies is limited to capital expenditures (approved by executive management, the Finance Committee of NASD's Board of Governors or NASD's Board of Governors) and regulatory projects specified by those groups as having a clear and direct link to protecting investors and ensuring market integrity, and (5) NASD reports annually to its Board of Governors the projects and purposes for which fine monies have been used.

ADVERTISING COSTS

The Company expenses advertising costs, which include media advertising and production costs. Advertising costs are recorded in the period incurred. Advertising costs totaled $10.5 million and $14.6 million for 2005 and 2004, respectively, and are included in general and administrative expense in the consolidated statements of income.

PENSION BENEFITS

The Company provides three non-contributory defined benefit pension plans for the benefit of eligible employees of its subsidiaries. The non-contributory defined benefit plans consist of a funded Employee Retirement Plan (ERP) and two unfunded SERP plans. Several statistical and other factors, which attempt to anticipate future events, are used in calculating the expense and liability related to the plans. Key factors include assumptions about the expected rates of return on plan assets and discount rates as determined by the Company, within certain guidelines. The Company considers market conditions, including changes in investment returns and interest rates, in making these assumptions. The Company determines the long-term rate of return based on analysis of historical and projected returns as prepared by the Company's actuary and external investment consultant. The discount rate used in the calculations is tracked to changes in Moody's Aa bond ratings. The Company's Pension Plan Committee approves both the expected long-term rate of return and the discount rate assumptions.

Unrecognized actuarial gains and losses are being recognized over time in accordance with SFAS No. 87, "Employers Accounting for Pensions." Unrecognized actuarial gains and losses arise from several factors, including experience and assumption changes in the obligations, and from the difference between expected returns and actual returns on plan assets.

The actuarial assumptions used by the Company in determining its pension benefits may differ materially from actual results due to changing market conditions and economic conditions, as well as early withdrawals by terminating plan participants. While the Company believes that the assumptions used are appropriate, differences in actual experience or changes in assumptions may materially affect the Company's financial position or results of operations.

STOCK COMPENSATION

NASDAQ accounts for stock option grants in accordance with Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees." NASDAQ grants stock options with an exercise price equal to the fair market value of the stock at the date of the grant, and accordingly, recognizes no compensation expense related to option grants.

As required under SFAS No. 123, "Accounting for Stock-Based Compensation," and SFAS No. 148 "Accounting for Stock-Based Compensation—Transition and Disclosure," pro forma information regarding net income has been determined as if NASDAQ had accounted for all stock option grants based on a fair value method. The fair value of each stock option grant was estimated at the date of grant using the Black-Scholes valuation model assuming a weighted-average expected life of five years, weighted-average

NASD 2005 Notes to Consolidated Financial Statements

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

expected volatility of 30.0 percent and a weighted-average risk-free interest rate of 4.05 percent and 3.43 percent for 2005 and 2004, respectively. The weighted-average fair value of options granted in 2005 and 2004 was $7.05 and $2.49, respectively. Pro forma net income includes the amortization of the fair value of stock options over the vesting period and the difference between the fair value and the purchase price of common shares purchased by employees under the employee stock purchase plan. The pro forma net income also includes a reduction in option expense due to the true-up of actual forfeitures. The pro forma information for the years ended December 31, 2005 and 2004 is as follows:

	2005	2004
	(in thousands)	
Income from continuing operations	$293,715	$105,135
Compensation expense (net of minority interest of $2,639 in 2005 and $1,784 in 2004)	(1,107)	(2,152)
Pro forma income from continuing operations	$292,608	$102,983

In December 2004, the FASB issued SFAS No. 123(R), which revises SFAS No. 123, supersedes APB No. 25 and amends SFAS No. 95. See "Recent Accounting Pronouncements" below.

INCOME TAXES

NASD, NASDR and NASD DR are tax-exempt organizations under the Internal Revenue Code (IRC) Section 501(c)(6). The Foundation is a tax-exempt organization under IRC Section 501(c)(4). All other consolidated subsidiaries of NASD are taxable entities. Deferred tax assets and liabilities are determined based on differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities (i.e., temporary differences) and are measured at the enacted rates that will be in effect when these differences are realized. If necessary, a valuation allowance is established to reduce deferred tax assets to the amount that is more likely than not to be realized.

ISSUANCE OF SUBSIDIARY STOCK

The Company recognizes gains and losses on issuances of subsidiary stock in members' equity.

FOREIGN CURRENCY TRANSLATION

Assets and liabilities of non-U.S. subsidiaries that operate in a local currency environment are translated to U.S. dollars at exchange rates in effect at the balance sheet date. Revenues and expenses are translated at average exchange rates during the year. Translation adjustments resulting from this process are charged or credited to the other comprehensive income component of members' equity.

MINORITY INTERESTS

Minority interests in the consolidated balance sheets represent the minority owners' share of equity of consolidated subsidiaries, principally NASDAQ, as of the balance sheet date. Minority interests in the consolidated statements of income represent the minority owners' share of the income or loss of consolidated subsidiaries.

NASD 2005 Notes to Consolidated Financial Statements

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

CONCENTRATION OF RISK

Financial instruments that potentially subject the Company to concentrations of risk consist primarily of cash and cash equivalents, available-for-sale and held-to-maturity investments, accounts receivable, and notes receivable. The Company does not require collateral on these financial instruments.

Cash and cash equivalents are maintained principally with financial institutions located in the U.S. that have high credit ratings. Risk on accounts receivable is reduced by the large number of entities comprising the Company's customer base and through ongoing evaluation of collectibility of amounts owed to the Company. NASD uses multiple outside investment managers to manage its investment portfolio and a custody agent, a publicly traded company located in New York, to hold a portion of NASD's available-for-sale investments.

The Company is economically dependent on two suppliers that provide telecommunications and information technology services to the Company. One of these two suppliers has recently emerged from bankruptcy. To the extent either of these suppliers is not able to perform, it could have an adverse effect on the Company's business.

The Company's business is transacted with multiple customers, with no individual customer exceeding 10 percent of total revenues.

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment," which revises SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS No. 123(R) also amended SFAS No. 95, "Statement of Cash Flows." SFAS No. 123(R) requires that new, modified and unvested share-based payment transactions with employees, such as stock options and restricted stock, be recognized in the financial statements based on their fair value and recognized as compensation expense over the vesting period. NASDAQ adopted SFAS No. 123(R) effective January 1, 2006, using the modified prospective transition method, and will recognize share-based compensation cost on a straight-line basis over the requisite service periods of awards. Under the modified prospective method, non-cash compensation expense will be recognized for the portion of outstanding stock option awards granted prior to the adoption of SFAS No. 123(R) for which service has not been rendered, and for any future stock option grants. The pro forma information presented in Note 12, "NASDAQ Stock Compensation, Stock Awards, and Capital Stock," presents the estimated compensation charges under SFAS No. 123(R). NASDAQ's assessment of the estimated compensation charges is affected by its stock price, as well as assumptions regarding a number of complex and subjective variables and related tax impact. These variables include, but are not limited to, NASDAQ's stock price volatility and employee stock option exercise behaviors.

In 2004, the Emerging Issues Task Force issued EITF No. 03-1, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments," to provide detailed guidance on assessing impairment losses on debt and equity investments. In September 2004, the FASB voted unanimously to delay the effective date of EITF No. 03-1. On November 3, 2005, the FASB issued FASB Staff Position FAS (FSP) No. 115-1, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments," revising the guidance in EITF No. 03-1. FSP No. 115-1 is effective on January 1, 2006. The Company is currently evaluating the impact of FSP No. 115-1 on its consolidated financial statements. The disclosures required by EITF No. 03-1 are included in Note 7, "Investments," to the consolidated financial statements.

NASD 2005 Notes to Consolidated Financial Statements

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

RECLASSIFICATIONS

Certain amounts for the prior year have been reclassified to conform to the 2005 presentation. For the years ended December, 31, 2005 and 2004, NASD classified the IARD program and CE program liabilities in other liabilities in the consolidated balance sheets. These amounts were previously reported in other current liabilities in the consolidated balance sheets.

3. NASDAQ RESTRUCTURING

On January 13, 2006, the SEC approved NASDAQ's application for registration as a national securities exchange (Exchange Registration). NASDAQ will begin operating as an exchange once it meets conditions imposed by the SEC. Upon effectiveness of Exchange Registration, NASDAQ will redeem the Series D Preferred Stock and NASD will no longer exert voting control over NASDAQ. Upon redemption of the Series D Preferred Stock, NASD will cease consolidating NASDAQ and will have reduced its ownership of NASDAQ to any remaining shares underlying the unexercised warrants for Tranche IV.

Previous NASD transactions in NASDAQ common stock included Phase I and Phase II sales of NASDAQ common stock and warrants in 2000 and 2001. As part of these transactions, NASD issued 10,806,494 warrants to purchase up to 43,225,976 shares of NASDAQ common stock from NASD in four annual tranches, with the first tranche beginning in 2002.

Preferred Stock

In March 2002, NASD sold 33.8 million shares of NASDAQ common stock to NASDAQ and received total consideration of $305.2 million in cash, 1,338,402 shares of Series A Cumulative Preferred Stock, and one share of Series B Preferred Stock. In December 2005, NASD exchanged its one share of Series B Preferred Stock for one newly issued share of Series D Preferred Stock, which has terms substantially similar to the terms of the Series B Preferred Stock. The Series D Preferred Stock does not pay dividends and provides NASD with voting control of NASDAQ.

Cumulative Preferred Stock

The Series A Cumulative Preferred Stock carried a 7.6 percent dividend rate for the year beginning in March 2003, and carried a 10.6 percent dividend rate in all subsequent years. On September 30, 2004, NASD waived a portion of the dividend for the third quarter of 2004 of $2.5 million and accepted an aggregate amount of $1.0 million (calculated based on an annual rate of 3.0 percent) as payment in full of the dividend for this period. In November 2004, NASD and NASDAQ entered into an exchange agreement pursuant to which NASD exchanged 1,338,402 shares of Series A Cumulative Preferred Stock for 1,338,402 shares of newly issued Series C Cumulative Preferred Stock. The Series C Cumulative Preferred Stock accrues quarterly dividends at an annual rate of 3.0 percent for all periods until July 1, 2006, and at 10.6 percent thereafter.

For the years ended December 31, 2005 and 2004, NASDAQ paid dividends of $3.2 million and $8.4 million, respectively. In 2004, NASDAQ recognized a loss of $3.9 million on the exchange of the Series A Cumulative Preferred Stock with the Series C Cumulative Preferred Stock. This loss was due to the difference between the combined fair market value of the Series C Cumulative Preferred Stock and additional dividend ($137.7 million) versus the redemption value ($133.8 million) of the Series A Cumulative Preferred Stock. For the years ended December 31, 2005 and 2004, NASDAQ recognized expenses of $3.4 million and $0.9 million, respectively, for the accretion of the Series C Cumulative Preferred Stock to its redemption value. As a result of these

NASD 2005 Notes to Consolidated Financial Statements

3. NASDAQ RESTRUCTURING (CONTINUED)

transactions, NASD realized an increase in its consolidated members' equity of $4.4 million and $2.2 million, representing the minority owners' portion of these transactions.

On April 21, 2005, NASD and NASDAQ entered into a Stock Repurchase and Waiver Agreement whereby NASD consented to the financing used in connection with the acquisition of Instinet. In exchange for the waiver, NASDAQ repurchased 384,932 shares of its Series C Cumulative Preferred Stock from NASD for approximately $40.0 million.

On February 15, 2006, NASDAQ redeemed all remaining outstanding shares of its Series C Cumulative Preferred Stock from NASD, as NASDAQ was required to redeem it after the closing, which took place on the same date of the public offering of its common stock. The total redemption price was $104.7 million.

Sales of NASDAQ Common Stock

On February 15, 2005, NASDAQ completed an underwritten secondary offering of 16,586,980 shares of common stock owned by NASD, and an additional 3,246,536 shares of common stock owned by certain selling stockholders that purchased the shares in NASDAQ's private placements in 2000 and 2001. NASDAQ, its officers, or other employees did not sell any shares in the secondary offering. NASD received net proceeds of $140.4 million and recognized a gain on the sale of subsidiary stock of $133.0 million.

On November 16, 2005, NASD completed a block trade of 4,500,000 shares of NASDAQ common stock. NASDAQ, its officers, or other employees did not sell any shares in the secondary offering. NASD received net proceeds of $161.3 million from this sale and recognized a gain on sale of subsidiary stock of $154.4 million.

On February 15, 2006, NASD sold 3,505,886 shares of NASDAQ common stock in NASDAQ's public offering. NASD received net proceeds of $129.1 million and recognized a gain on sale of subsidiary stock of $121.8 million. On March 2, 2006, the underwriters for NASDAQ's public offering exercised its option and purchased an additional 1,042,142 shares of common stock from NASD. NASD received net proceeds of $40.0 million on this sale and recognized a gain on sale of subsidiary stock of $34.8 million.

Warrants to Purchase NASDAQ Common Stock from NASD

Tranche I expired on June 27, 2003 and prior to the expiration, NASD issued 35,830 shares of NASDAQ common stock for the exercise of warrants, generating proceeds of $0.5 million and a gain of $0.4 million. Upon expiration of Tranche I, 10,770,664 shares of common stock underlying unexercised warrants reverted back to NASD. Tranche II expired on June 25, 2004, and 6,750 shares of NASDAQ common stock were issued following the exercise of warrants, generating proceeds and a gain of $0.1 million. Following expiration of Tranche II, 10,799,744 shares of common stock underlying the unexercised warrants reverted back to NASD. Tranche III expired on June 27, 2005, and NASD issued 6,741,894 million shares of NASDAQ common stock for exercises of warrants, generating proceeds of $101.1 million and a gain of $95.2 million. Upon expiration of Tranche III, 4,064,600 shares of common stock underlying unexercised warrants reverted back to NASD. Tranche IV expires on June 27, 2006. As of December 31, 2005, NASD issued 87,675 shares of NASDAQ common stock for exercises of warrants under Tranche IV, generating proceeds to NASD of $1.4 million and a gain of $1.2 million.

As of December 31, 2005, NASD owned 18.4 percent of NASDAQ common stock, 100 percent of NASDAQ Series C Cumulative Preferred Stock, and 100 percent of NASDAQ Series D Preferred Stock.

NASD 2005 Notes to Consolidated Financial Statements

4. NASDAQ BUSINESS COMBINATIONS

PURCHASE ACQUISITIONS AND COMBINATIONS

NASDAQ completed the following acquisitions and asset purchases in 2005 and 2004:

- Acquisition of Instinet Group, December 8, 2005 – Through this acquisition, NASDAQ acquired the INET ECN. NASDAQ expects to migrate its existing NASDAQ and Brut trading platforms to the INET platform by the fourth quarter of 2006.
- Acquisition of Carpenter Moore, October 1, 2005 – NASDAQ acquired Carpenter Moore to increase NASDAQ's depth of brokerage expertise in directors and officers, errors and omissions and other management liability insurance products, and to expand the regional coverage by NASDAQ's insurance business through Carpenter Moore's unique co-brokerage distribution model. NASDAQ's acquisition encompasses four of Carpenter Moore's geographic locations, including California, Texas, Minnesota and Massachusetts.
- Purchase of remaining 50.0 percent interest in the NASDAQ Insurance Agency, January 1, 2005 – NASDAQ purchased the remaining 50.0 percent interest in the NASDAQ Insurance Agency from AIG. The purchase did not have any impact on the operations of the agency. As of January 1, 2005, NASDAQ consolidated NASDAQ Insurance Agency's financial position and results of operations in its consolidated financial statements. Before January 1, 2005, NASDAQ accounted for its investment in NASDAQ Insurance Agency under the equity method of accounting.
- Acquisition of Brut, September 7, 2004 – NASDAQ acquired Brut to enhance its execution quality, provide additional quote information and create a deeper pool of liquidity in NASDAQ-listed securities and securities listed on other exchanges.

The following table presents a summary of the acquisitions and asset purchases in 2005 and 2004:

	Purchase Consideration	Total Net (Liabilities) Assets Acquired [1]	Purchased Intangible Assets	Goodwill
		(in thousands)		
2005				
INET	$ 968,900	$ (3,100)	$ 172,870	$ 799,130
Carpenter Moore	27,500 [2]	240	8,600	18,660
NASDAQ Ins. Agency	–	(1,577)	1,000	577
Total for 2005	996,400	(4,437)	182,470	818,367
2004				
Brut	190,000	6,270	42,000	141,730
Total	$ 1,186,400	$ 1,833	$ 224,470	$ 960,097

(1) NASDAQ acquired net assets of INET totaling $64.7 million and recorded non-current deferred tax liabilities of $67.8 million related to INET's intangible assets resulting in total net liabilities acquired of $3.1 million. NASDAQ acquired net assets of Carpenter Moore totaling $2.5 million and recorded non-current deferred tax liabilities of $2.3 million related to Carpenter Moore's intangible assets resulting in total net assets of $0.2 million.

(2) Includes $11.8 million held in escrow for post-closing settlement adjustments. This balance will be paid over the next three years in accordance with the purchase agreement.

NASD 2005 Notes to Consolidated Financial Statements

4. NASDAQ BUSINESS COMBINATIONS (CONTINUED)

As of September 7, 2005, NASDAQ finalized the allocation of the purchase price for the acquisition of Brut, except for related tax adjustments. The purchase price allocation for NASDAQ's other acquisitions and asset purchases will be finalized within one year from the purchase date. NASDAQ expects future adjustments related to taxes and settlement of post-closing adjustments.

The consolidated financial statements include the operating results of each business from the date of acquisition. Unaudited pro forma combined historical results for the years ended December 31, 2005 and 2004 are included in the table below. For the years ended December 31, 2005 and 2004, the unaudited pro forma combined historical results combine the historical consolidated statements of income of NASD with Brut and INET, giving effect to the acquisitions as if they had occurred on January 1, 2004, respectively. The acquisitions of Carpenter Moore and NASDAQ Insurance Agency are not included in these pro forma results as these acquisitions were not considered significant.

	YEARS ENDED DECEMBER, 31, 2005	2004
	(in thousands)	
Revenues	$ 2,269,800	$ 1,891,171
Net revenue	1,235,682	1,194,351
Net income from continuing operations (net of minority interest expense of $20,470 in 2005 and $5,197 in 2004)	$ 302,298	$ 111,405

The pro forma results include amortization of the intangible assets presented above and the elimination of intercompany transactions had NASD, Brut and INET acted as a combined company. The pro forma results are not necessarily indicative of what actually would have occurred if the acquisitions had been completed as of the beginning of 2004, nor are they necessarily indicative of future consolidated results.

NASD 2005 Notes to Consolidated Financial Statements

4. NASDAQ BUSINESS COMBINATIONS (CONTINUED)

Purchased Intangible Assets

The following table presents the details of the purchased intangible assets acquired during 2005 and 2004:

	TECHNOLOGY		CUSTOMER RELATIONSHIP		OTHER		TOTAL
	Estimated Useful Life	Amount	Estimated Useful Life	Amount	Estimated Useful Life	Amount	Amount
	(in thousands, except estimated useful lives, which are in years)						
2005							
INET	5	$ 9,400	13	$ 163,100	1	$ 370	$ 172,870
Carpenter Moore	10	1,000	20	6,000	4.5	1,600	8,600
NASDAQ Ins. Agency	–	–	7	1,000	–	–	1,000
Total for 2005		10,400		170,100		1,970	182,470
2004							
Brut	10[1]	15,700	10	26,300	–	–	42,000
Total		$ 26,100		$ 196,400		$ 1,970	$ 224,470

[1] The Brut technology software license was originally amortized over an estimated useful life of 10 years on a straight-line basis. As a result of NASDAQ's acquisition of INET and NASDAQ's plans to replace Brut's technology with INET technology, a recoverability test was performed pursuant to SFAS No. 144, as the acquisition and planned technology retirement was deemed an impairment "triggering event." As a result of the recoverability test, NASDAQ determined that the Brut technology software license was not impaired. However, as a result of the plans, NASDAQ changed the estimated useful life of the technology software license to nine months, consistent with the planned implementation of INET technology.

Amortization expense for purchased intangible assets was $7.5 million and $1.7 million for the years ended December 31, 2005 and 2004, respectively. The estimated future amortization expense of purchased intangible assets as of December 31, 2005 is as follows:

	(in thousands)
2006	$ 30,214
2007	18,064
2008	17,864
2009	17,833
2010	17,565
Thereafter	113,938
Total	$ 215,478

4. NASDAQ BUSINESS COMBINATIONS (CONTINUED)

Goodwill

The increase in goodwill in 2005 primarily relates to the acquisitions discussed above and settlement of post-closing adjustments related to the acquisition of Brut. NASDAQ expects to deduct approximately $9.5 million of goodwill for income tax purposes for the year ended December 31, 2005.

ACQUISITION OF JOINT VENTURE

On June 7, 2005, NASDAQ and Reuters announced the formation of the Independent Research Network (IRN), a new joint venture created to help public companies obtain independent analyst coverage. The IRN's business plan is to aggregate multiple, independent research providers to procure and distribute equity research on behalf of under-covered companies to increase the market's understanding of a company's fundamental prospects. The service will be targeted to all companies listed in the U.S., as well as private companies looking for research coverage.

To fund the operations of the IRN, NASDAQ and Reuters contributed $1.8 million and $1.2 million, respectively, in July 2005. The IRN began operations in the third quarter of 2005 and NASDAQ consolidated IRN's financial position and results of operations. As of December 31, 2005, NASDAQ recorded minority interest of approximately $1.0 million in the consolidated balance sheets for Reuters' share of IRN's equity.

5. NASDAQ 2005 AND 2004 COST REDUCTIONS AND STRATEGIC REVIEW

2005 AND 2004 COST REDUCTIONS

During 2005 and 2004, in connection with actions NASDAQ took to improve operational efficiency, NASDAQ incurred expenses of approximately $20.0 million and $62.6 million, respectively. The following table summarizes the cost reduction charges included in the consolidated statements of income:

	YEARS ENDED DECEMBER 31,	
	2005	2004
	(in millions)	
Real estate consolidation, net	$ (5.4)	$ 29.0
Reductions in force	4.6	9.4
Technology migration	20.8	24.2
Total cost reduction charges	$ 20.0	$ 62.6

Real Estate Consolidation

During 2004, NASDAQ's management re-evaluated all of NASDAQ's owned and leased real estate and determined that NASDAQ would consolidate staff into fewer locations and save significant costs. As part of this re-evaluation, management decided not to occupy expansion space that it had leased at NASDAQ's headquarters in New York. As a result, for the year ended December 31, 2004, NASDAQ recorded charges of $29.0 million. However, as a result of the acquisition of INET, management has now

NASD 2005 Notes to Consolidated Financial Statements

5. NASDAQ 2005 AND 2004 COST REDUCTIONS AND STRATEGIC REVIEW (CONTINUED)

determined that NASDAQ will occupy the expansion space for INET operations. As a result of this decision, NASDAQ recorded a release of part of the sublease loss reserve recorded in 2004, resulting in a net benefit of $5.4 million for the year ended December 31, 2005. More detail on the lease at headquarters, as well as NASDAQ's other leased, subleased, and owned properties are provided below.

New York

As of December 31, 2003, NASDAQ had a sublease loss reserve of $20.5 million related to its leased property at 1500 Broadway. In 2004, NASDAQ signed subleases for all of its space at 1500 Broadway. As of December 31, 2005 and 2004, NASDAQ updated the sublease loss estimate based on current assumptions and known sublease incomes and recorded an additional loss of $1.7 million and $1.2 million, respectively, to general and administrative expense in the consolidated statements of income. In 2005, the additional loss recorded was primarily due to an increase in real estate taxes as a result of a reassessment of the building. The additional loss recorded in 2004 was primarily due to a change in the assumption of sublease term commencement dates.

During 2004, NASDAQ recorded a sublease loss reserve of $12.8 million, included in general and administrative expense in the consolidated statements of income, on a lease for expansion space at its headquarters in New York, which was to commence on October 1, 2004. NASDAQ began marketing the expansion space for sublease during the third quarter of 2004. NASDAQ is obligated under the terms of the expansion space lease to pay $33.9 million over the remaining life of the lease. As a result of the INET acquisition and NASDAQ's intention to occupy the expansion space, NASDAQ released the sublease loss reserve recorded for the expansion space. This loss reserve totaled $12.1 million, net of fourth quarter of 2005 rental payments, which is also recorded in general and administrative expense in the consolidated statements of income.

In the fourth quarter of 2004, NASDAQ's management decided to consolidate additional space at its headquarters in New York and recorded an additional estimated sublease loss reserve of $4.8 million for such space. This charge is included in general and administrative expense in the consolidated statements of income. NASDAQ is obligated under the terms of this lease to pay $12.6 million over the remaining useful life of the lease. In 2005, NASDAQ signed a sublease for this space with NASD.

New Jersey

As a part of NASDAQ's strategic review, NASDAQ vacated the space NASDAQ Tools occupied at 15 Exchange Place, Jersey City, New Jersey. As of December 31, 2003, NASDAQ was obligated under the terms of this lease to pay $2.8 million over the remaining life of the lease and recorded a sublease loss reserve of $1.2 million. As of December 31, 2005 and 2004, NASDAQ updated the sublease loss reserve based on current assumptions and recorded an additional loss of $0.6 million and $0.2 million, respectively, to general and administrative expense in the consolidated statements of income.

Maryland

During 2003, NASDAQ decided to vacate part of the space it occupies in Rockville, Maryland located at 9600 Blackwell Road and recorded a sublease loss reserve of $2.3 million. NASDAQ's management re-evaluated its decision to vacate the space at 9600 Blackwell and decided instead to sell the building it owned and occupied in Rockville, Maryland located at 9513 Key West Avenue. Based on NASDAQ's management's revised decision, NASDAQ released the sublease loss reserve recorded for 9600 Blackwell. As of September 30, 2004, this loss reserve totaled $1.9 million, net of rental payments, and its release is recorded as a reduction of general and administrative expense in the consolidated statements of income.

NASD 2005 Notes to Consolidated Financial Statements

5. NASDAQ 2005 AND 2004 COST REDUCTIONS AND STRATEGIC REVIEW (CONTINUED)

NASDAQ began actively marketing the 9513 Key West building for sale in the fourth quarter of 2004 and in June 2005 completed the sale of the building to NASD for $18.0 million. During the fourth quarter of 2004, NASDAQ recognized a $7.4 million loss, which is included in general and administrative expense in the consolidated statement of income, for the write-down of the building's carrying amount to fair market value less cost to sell. Fair value was determined using a quoted market price from an independent third party. The building was classified as held-for-sale and was included in land, buildings and improvements in the consolidated balance sheets with a carrying value of $17.6 million as of December 31, 2004. This facility was NASDAQ's disaster recovery site. In September 2005, NASDAQ relocated its disaster recovery site to a third party outsource facility. As a result of vacating the Key West building, NASDAQ recorded $2.1 million of accelerated depreciation for certain assets for the year ended December 31, 2005.

Connecticut

In 2004, NASDAQ also evaluated its real estate needs in Trumbull, Connecticut. NASDAQ currently owns and occupies a building located at 80 Merritt Boulevard and leases and occupies another building located at 35 Nutmeg Drive. NASDAQ's management determined that, based on staff reductions, all employees in Trumbull would consolidate into NASDAQ's building at 80 Merritt Boulevard. Although NASDAQ's lease at 35 Nutmeg Drive terminates in July 2008, NASDAQ planned on moving all employees from 35 Nutmeg Drive to 80 Merritt Boulevard before the end of the lease. To accommodate all employees in the Merritt building, two data center spaces were converted into office space. The data centers ceased being used by the end of the first quarter of 2005, and accordingly, NASDAQ began accelerating the data centers' fixed assets and leasehold improvements over the new estimated useful life. NASDAQ recorded $4.5 million of accelerated depreciation for the data center assets for the year ended December 31, 2004, and recorded an additional $2.3 million in the first quarter of 2005. As a result of the acquisition of INET, NASDAQ's management continues to evaluate its real estate needs in Connecticut. This evaluation may result in additional consolidations and charges in 2006.

Sublease Loss Reserves

As of December 31, 2005 and 2004, the estimated sublease loss reserve for all subleased properties was approximately $23.2 million and $36.7 million, respectively, and is included in accounts payable and accrued expenses and other liabilities in the consolidated balance sheets. The reserve is adjusted throughout the year to reflect interest accretion, rental payments made during the year, depreciation on leasehold improvements, if applicable, and sublease receipts. The estimated losses were calculated using a 7.5 percent net discount rate and estimated sublease terms ranging from five years to 20 years at estimated market rates.

Reductions in Force

During the years ended December 31, 2005 and 2004, NASDAQ eliminated 69 and 172 positions, respectively, associated with staff reduction plans and recorded charges of $4.6 million and $9.4 million, respectively, for severance and outplacement costs. These costs are included in compensation and benefits expense in the consolidated statements of income. NASDAQ paid approximately $5.8 million and $4.9 million during the years ended December 31, 2005 and 2004, respectively, for these severance and outplacement costs from the staff reduction plans. NASDAQ expects to pay the remainder of the severance and outplacement costs by the end of the third quarter of 2007. Total headcount increased from 786 employees at December 31, 2004 to 865 employees at December 31, 2005, as a result of employees acquired in the INET, Carpenter Moore, and NASDAQ Insurance Agency transactions, partially offset by staff reductions.

NASD 2005 Notes to Consolidated Financial Statements

5. NASDAQ 2005 AND 2004 COST REDUCTIONS AND STRATEGIC REVIEW (CONTINUED)

Technology Migration

As a result of a continued review of its technology infrastructure in 2005 and 2004, NASDAQ shortened the estimated useful life of certain assets and changed the lease terms on certain operating leases associated with its quoting platform and its trading and quoting network as it migrates to lower cost operating environments. Shortening the estimated useful life of the assets resulted in incremental depreciation and amortization expense. The incremental depreciation and amortization expense associated with these assets was $4.2 million for the year ended December 31, 2005, and $18.7 million for the year ended December 31, 2004. These amounts included both incremental depreciation and amortization expense on these assets and operating leases.

In November 2004, NASDAQ purchased a technology platform held-for-sale and owned by Easdaq, for €1.9 million ($2.4 million). Additionally, in order to make use of the purchased technology platform, NASDAQ purchased a license for the use of certain software for $0.5 million. NASDAQ had a multi-year initiative to migrate The NASDAQ Market Center applications to lower cost operating environments and processes. The purchased platform was intended to provide a baseline of functionality for The NASDAQ Market Center. As a result of the migration initiative, NASDAQ shortened the estimated useful life of its then-current application platform and, in addition to the incremental depreciation and amortization expense of $4.2 million and $18.7 million discussed above, NASDAQ recorded incremental amortization expense of $10.8 million and $2.9 million for the years ended December 31, 2005 and 2004, respectively.

As a result of the acquisition of INET, NASDAQ will now migrate The NASDAQ Market Center to INET's lower cost trading system by the fourth quarter of 2006. NASDAQ believes that INET's technology platform will enable it to compete more effectively and deliver increased capabilities demanded by its customers. Therefore, beginning December 8, 2005, NASDAQ recorded additional amortization expense of $5.8 million due to a change in estimated useful life of some of The NASDAQ Market Center assets including the purchased technology platform from Easdaq and NASDAQ's current application platform. The additional amortization expense also includes a change in estimated useful life of the Brut technology license intangible asset as NASDAQ will no longer use this technology license once the migration to INET's trading platform is completed.

In October 2004, NASDAQ entered into an agreement for technology equipment and also renegotiated related operating leases with a major vendor. NASDAQ sold equipment with a net book value of $13.6 million and entered into a three-year lease agreement, which included new upgraded equipment. NASDAQ received $11.0 million in cash from the vendor and recognized a $2.6 million loss on this transaction. This loss is included in general and administrative expense in the consolidated statements of income. NASDAQ paid $8.2 million and $1.6 million in 2005 and 2004, respectively, and will pay $0.4 million in both 2006 and 2007 under the terms of the lease agreement. NASDAQ also upgraded related leased equipment and entered into a new three-year operating lease and extended the terms of license and maintenance agreements. Under the terms of the operating lease and license and maintenance agreements, NASDAQ paid $15.3 million and $11.2 million in 2005 and 2004, respectively, and will pay $9.0 million and $3.0 million in 2006 and 2007, respectively.

STRATEGIC REVIEW

During the second quarter of 2003, NASDAQ announced the results of a strategic review of its operations designed to position NASDAQ for improved profitability and growth. This strategic review included the elimination of non-core product lines and initiatives and resulted in a reduction in NASDAQ's workforce. The liability for strategic review costs is recorded in other accrued liabilities and accrued personnel costs in the current liabilities section and in other liabilities in the non-current liabilities section of

NASD 2005 Notes to Consolidated Financial Statements

5. NASDAQ 2005 AND 2004 COST REDUCTIONS AND STRATEGIC REVIEW (CONTINUED)

the consolidated balance sheets. NASDAQ funded the majority of these reserves, except for a $4.6 million contract payment that it paid in January 2006, and other contractual sublease obligations that will continue through 2010.

	Severance for U.S. Employees	Products & Other	Total
		(in millions)	
Accrued liabilities associated with the strategic review, as of December 31, 2004	$ 5.4	$ 0.9	$ 6.3
Cash payments	(0.7)	(0.5)	(1.2)
Other	–	0.7	0.7
Accrued liabilities associated with the strategic review, as of December 31, 2005	$ 4.7	$ 1.1	$ 5.8

6. DEFERRED REVENUE

NASD

In June 2003, the Emerging Issues Task Force finalized EITF No. 00-21, "Revenue Arrangements with Multiple Deliverables," which became effective for NASD's consolidated financial statements on January 1, 2004. This accounting pronouncement requires revenue arrangements be reviewed to determine (a) how the arrangement consideration should be measured, (b) whether the arrangement should be divided into separate units of accounting, and (c) how the arrangement consideration should be allocated among the separate units of accounting. Once each element of a revenue arrangement has been identified, EITF No. 00-21 requires companies to recognize the revenue for such element in accordance with existing accounting literature. EITF No. 00-21 does not address when the criteria for revenue recognition are met or provide guidance on the appropriate revenue recognition convention for a given unit of accounting. NASD performed a comprehensive review of all revenue arrangements in 2004 and concluded that this new accounting pronouncement was applicable to NASD's registration fees and arbitration fees.

As a result of this review, NASD changed its method of accounting for revenue recognition for these fees. The first year's registration fee consists of two elements, an upfront initial fee and an annual fee. NASD has segregated the initial and annual components of this fee using the residual value approach within EITF No. 00-21 and defers and amortizes the initial fee element over an estimated customer relationship period of 10 years for firms and three and a half years for individual representatives. Fees received on open arbitration cases also include multiple elements. These fees are deferred and amortized over the average life of an arbitration case, or 15 months. Registration fees are included within user fees and arbitration fees are included within dispute resolution fees in the consolidated statements of income.

NASD 2005 Notes to Consolidated Financial Statements

6. DEFERRED REVENUE (CONTINUED)

NASD recognized a one-time cumulative effect of change in accounting principle as of January 1, 2004, of $58.3 million. The adjustment to 2004 net income for the cumulative change to prior years' results consists of the following:

	(in thousands)
Registration	$ (28,533)
Arbitration	(29,809)
Cumulative effect of change in accounting principle	$ (58,342)

In 2005 and 2004, NASD recognized an aggregate of $8.6 million and $40.4 million, respectively, in revenue that was deferred as part of the cumulative effect adjustment as of January 1, 2004.

Following is a summary of amounts included in NASD's current and non-current deferred revenue as of December 31, 2005, and the years over which those amounts will be recognized:

	Registration	Arbitration	Annual and Other	Total
		(in thousands)		
Fiscal year ended:				
2006	$ 10,713	$ 21,470	$ 28,868	$ 61,051
2007	7,467	556	–	8,023
2008	4,266	–	–	4,266
2009	1,536	–	–	1,536
2010 and thereafter	2,950	–	–	2,950
	$ 26,932	$ 22,026	$ 28,868	$ 77,826

Following is a summary of activity in NASD current and non-current deferred revenue for the year ended December 31, 2005 and 2004 for all revenue arrangements. The additions reflect the fees charged during the year while the amortization reflects the revenues recognized during the year based on the accounting methodology described above.

	Registration	Arbitration	Annual and Other	Total
		(in thousands)		
Balance as of January 1, 2005	$ 27,265	$ 30,139	$ 37,822	$ 95,226
Additions	12,320	38,601	138,632	189,553
Amortization	(12,653)	(46,714)	(147,586)	(206,953)
Balance as of December 31, 2005	$ 26,932	$ 22,026	$ 28,868	$ 77,826

NASD 2005 Notes to Consolidated Financial Statements

6. DEFERRED REVENUE (CONTINUED)

	Registration	Arbitration	Annual and Other	Total
		(in thousands)		
Balance as of January 1, 2004	$ 28,461	$ 29,809	$ 36,879	$ 95,149
Additions	12,101	52,240	48,862	113,203
Amortization	(13,297)	(51,910)	(47,919)	(113,126)
Balance as of December 31, 2004	$ 27,265	$ 30,139	$ 37,822	$ 95,226

NASDAQ

NASDAQ's deferred revenue at December 31, 2005 was primarily related to Corporate Client Group fees and will be recognized in the following years:

	Initial	LAS	Annual and Other	Total
		(in thousands)		
Fiscal year ended:				
2006	$ 21,199	$ 31,226	$ 1,168	$ 53,593
2007	16,173	24,957	–	41,130
2008	13,504	14,704	–	28,208
2009	10,173	3,879	–	14,052
2010 and thereafter	8,629	–	–	8,629
Total	$ 69,678	$ 74,766	$ 1,168	$ 145,612

NASDAQ's deferred revenue for the years ended December 31, 2005 and 2004 is reflected in the following tables. The additions reflect Corporate Client Group revenues charged during the year, while the amortization reflects Corporate Client Group revenues recognized during the year in accordance with U.S. generally accepted accounting principles.

	Initial	LAS	Annual and Other	Total
		(in thousands)		
Balance at January 1, 2005	$ 74,300	$ 75,058	$ –	$ 149,358
Additions	24,570	37,411	116,807	178,788
Amortization	(29,192)	(37,703)	(115,639)	(182,534)
Balance at December 31, 2005	$ 69,678	$ 74,766	$ 1,168	$ 145,612

NASD 2005 Notes to Consolidated Financial Statements

6. DEFERRED REVENUE (CONTINUED)

	Initial	LAS	Annual and Other	Total
		(in thousands)		
Balance at January 1, 2004	$ 78,485	$ 65,957	$ –	$ 144,442
Additions	26,905	45,846	97,446	170,197
Amortization	(31,090)	(36,745)	(97,446)	(165,281)
Balance at December 31, 2004	$ 74,300	$ 75,058	$ –	$ 149,358

7. INVESTMENTS

NASD

Available-for-Sale Investments

NASD's investments principally consist of mutual/commingled funds, auction rate securities, equity securities, U.S. Treasury securities, obligations of government-sponsored enterprises, U.S. corporate debt securities, and other financial instruments. The following is a summary of investments classified as available-for-sale, which are carried at fair value as of December 31, 2005:

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
		(in millions)		
U.S. Treasury securities	$ 45.4	$ 0.3	$ 0.7	$ 45.0
Debt securities issued by government-sponsored enterprises	69.9	0.2	0.8	69.3
Obligations of states and political subdivisions	2.0	0.2	–	2.2
Debt securities issued by foreign governments	4.4	0.3	0.2	4.5
Asset-backed securities	4.1	0.2	0.1	4.2
U.S. corporate debt securities	59.3	0.4	1.0	58.7
Other debt securities	22.5	0.1	0.5	22.1
Auction rate securities	291.0	–	–	291.0
Total debt securities	498.6	1.7	3.3	497.0
Mutual/commingled funds	863.5	69.7	2.3	930.9
Equity securities	274.9	46.2	4.1	317.0
Total	$ 1,637.0	$ 117.6	$ 9.7	$ 1,744.9

Unrealized gains (losses) from available-for-sale securities recorded in members' equity also include NASD's share of available-for-sale securities unrealized gains (losses) of equity investees.

NASD 2005 Notes to Consolidated Financial Statements

7. INVESTMENTS (CONTINUED)

Following is a summary of investments classified as available-for-sale, which are carried at fair value as of December 31, 2004:

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
		(in millions)		
U.S. Treasury securities	$ 25.3	$ 0.5	$ –	$ 25.8
Debt securities issued by government-sponsored enterprises	11.8	–	0.1	11.7
Obligations of states and political subdivisions	2.1	0.1	–	2.2
Debt securities issued by foreign governments	4.7	0.1	–	4.8
Asset-backed securities	31.7	0.2	0.2	31.7
U.S. corporate debt securities	61.1	0.9	0.3	61.7
Other debt securities	30.9	0.6	0.6	30.9
Auction rate securities	173.1	–	–	173.1
Total debt securities	340.7	2.4	1.2	341.9
Mutual/commingled funds	561.9	40.2	1.3	600.8
Equity securities	229.6	37.3	2.7	264.2
Total	$ 1,132.2	$ 79.9	$ 5.2	$ 1,206.9

Following is a summary, by contractual maturity, of investments classified as available-for-sale as of December 31, 2005:

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
		(in millions)		
Due in one year or less	$ 12.5	$ –	$ 0.3	$ 12.2
Due after one through five years	77.2	0.6	1.4	76.4
Due after five through 10 years	23.1	0.2	0.2	23.1
Due after 10 years	385.8	0.9	1.4	385.3
Total debt securities	498.6	1.7	3.3	497.0
Mutual/commingled funds	863.5	69.7	2.3	930.9
Equity securities	274.9	46.2	4.1	317.0
Total	$ 1,637.0	$ 117.6	$ 9.7	$ 1,744.9

The gross realized gains on sales in 2005 and 2004 totaled $36.6 million and $51.7 million, respectively, and the gross realized losses totaled $10.1 million and $19.1 million, respectively. Included within gross realized gains (losses) are reclassifications from unrealized gains (losses) after taxes on available-for-sale securities of $21.0 million and $39.9 million in 2005 and 2004, respectively. These reclassifications represent the recognition of amounts previously recorded as unrealized gain (loss) as of the end of the previous year. For the years ended December 31, 2005 and 2004, NASD recognized net investment gains from its investments in mutual/commingled funds of $17.6 million and ($4.7) million, respectively. These gains are included in net realized investment gains in the consolidated statements of income.

NASD 2005 Notes to Consolidated Financial Statements

7. INVESTMENTS (CONTINUED)

Temporary Declines in Fair Market Value

For the year ended December 31, 2005, NASD recorded impairment charges of $10.6 million related to 38 publicly traded equity securities, and $12.7 million on two investments in mutual/commingled funds. For the year ended December 31, 2004, NASD recorded impairment charges of $3.1 million related to 12 publicly traded equity securities. The impairment charges related to declines in the fair value of its investments that were judged to be other-than-temporary and are reflected in net realized investment gains (losses) in the consolidated statements of income.

The following table shows the fair value of NASD's available-for-sale investments with an unrealized loss position deemed to be temporary for less than 12 months and greater than 12 months as of December 31, 2005 and 2004.

	2005			2004		
	Fair Market Value	Gross Unrealized Loss		Fair Market Value	Gross Unrealized Loss	
		Less Than 12 Months	Greater Than 12 Months		Less Than 12 Months	Greater Than 12 Months
	(in millions)					
U.S. Treasury securities	$ 36.1	$ 0.7	$ –	$ –	$ –	$ –
Debt securities issued by government-sponsored enterprises	45.8	0.6	0.2	6.4	0.1	–
Debt securities issued by foreign governments	2.5	0.2	–	–	–	–
Asset-backed securities	3.4	0.1	–	10.2	0.1	0.1
U.S. corporate debt securities	36.5	0.8	0.2	18.5	0.2	0.1
Other debt securities	15.2	0.2	0.3	18.8	0.3	0.3
Total debt securities	139.5	2.6	0.7	53.9	0.7	0.5
Mutual/commingled funds	92.1	1.2	1.1	122.7	1.3	–
Equity securities	55.4	4.1	–	51.0	2.7	–
Total	$ 287.0	$ 7.9	$ 1.8	$ 227.6	$ 4.7	$ 0.5

As of December 31, 2005 and 2004, NASD had 280 and 172 securities in an unrealized loss position, respectively. For securities with unrealized losses greater than 12 months as of December 31, 2005, the fair market values were $2.2 million, $6.6 million, $2.2 million, and $26.1 million for investments in debt securities issued by government-sponsored enterprises, U.S. corporate debt securities, other debt securities, and mutual/commingled funds, respectively. For securities with unrealized losses greater than 12 months as of December 31, 2004, the fair market values were $1.1 million, $1.3 million and $3.0 million for asset-backed securities, U.S. corporate debt securities, and other debt securities, respectively.

NASD 2005 Notes to Consolidated Financial Statements

7. INVESTMENTS (CONTINUED)

NASDAQ

Available-for-Sale Investments

NASDAQ's available-for-sale investments consist of U.S. Treasury securities, obligations of U.S. government-sponsored enterprises, municipal bonds, auction rate securities and other financial instruments. The following is a summary of investments classified as available-for-sale, which are carried at fair market value as of December 31, 2005:

	Amortized Cost	Gross Unrealized Loss	Fair Value
		(in millions)	
Debt securities issued by government-sponsored enterprises	$ 50.4	$ 0.8	$ 49.6
Obligations of states and political subdivisions	6.0	–	6.0
Auction rate securities	123.9	0.1	123.8
Total securities	$ 180.3	$ 0.9	$ 179.4

Following is a summary of investments classified as available-for-sale, which are carried at fair market value as of December 31, 2004:

	Amortized Cost	Gross Unrealized		Fair Value
		Gain	Loss	
		(in millions)		
U.S. Treasury securities	$ 5.0	$ –	$ –	$ 5.0
Debt securities issued by government-sponsored enterprises	52.9	–	0.7	52.2
Obligations of states and political subdivisions	53.2	0.1	0.9	52.4
U.S. corporate debt securities	19.2	–	0.1	19.1
Auction rate securities	46.1	–	–	46.1
Total securities	$ 176.4	$ 0.1	$ 1.7	$ 174.8

NASD 2005 Notes to Consolidated Financial Statements

7. INVESTMENTS (CONTINUED)

The cost and estimated fair market value of debt securities classified as available-for-sale that are carried at fair market value at December 31, 2005, by contractual maturity, are shown below.

	Cost	Gross Unrealized Loss	Fair Market Value
		(in millions)	
Due in one year or less	$ 54.5	$ 0.3	$ 54.2
Due after one through five years	125.8	0.6	125.2
Total	$ 180.3	$ 0.9	$ 179.4

During the years ended December 31, 2005 and 2004, debt available-for-sale securities with a fair market value at the date of sale of $51.3 million and $173.2 million, respectively, were sold. For the years ended December 31, 2005 and 2004, the gross realized gains on such sales totaled $0.1 million for both years, and the gross realized losses totaled $1.6 million and $0.3 million, respectively. The net adjustment, after tax, to unrealized holding losses on available-for-sale securities included as a separate component of members' equity totaled $1.2 million and $1.0 million for 2005 and 2004, respectively. The net adjustment after tax to unrealized (gains) losses on available-for-sale securities included as a separate component of members' equity due to the sale of securities totaled ($0.4) million and $0.1 million for 2005 and 2004, respectively.

Temporary Declines in Fair Market Value

The following table shows the fair value of NASDAQ's available-for-sale investments with an unrealized loss position deemed to be temporary for less than 12 months and greater than 12 months as of December 31, 2005 and 2004.

	2005			2004		
	Fair Market Value	Gross Unrealized Loss		Fair Market Value	Gross Unrealized Loss	
		Less Than 12 Months	Greater Than 12 Months		Less Than 12 Months	Greater Than 12 Months
			(in millions)			
Debt securities issued by government-sponsored enterprises	$ 49.5	$ –	$ 0.8	$ 52.2	$ 0.7	$ –
Obligations of states and political subdivisions	–	–	–	50.6	0.9	–
U.S. corporate debt securities	–	–	–	15.0	0.1	–
Auction rate securities	18.1	0.1	–	–	–	–
Total securities	$ 67.6	$ 0.1	$ 0.8	$ 117.8	$ 1.7	$ –

Held-to-Maturity Investments

As of December 31, 2004, all held-to-maturity investments consisted of U.S. Treasury securities and obligations of government-sponsored enterprises. The cost of the securities was $30.6 million and had gross unrealized losses of $0.4 million and a total

NASD 2005 Notes to Consolidated Financial Statements

7. INVESTMENTS (CONTINUED)

estimated fair value of $30.2 million. Of the investments having $0.4 million of gross unrealized losses, 98.9 percent had been in an unrealized loss position for less than 12 months and are deemed to be temporary.

In conjunction with the financing of the Instinet acquisition, NASDAQ was obligated to repay in full the $25.0 million senior notes. As a result, in November 2005, held-to-maturity investments consisting of U.S. Treasury securities and obligations of government-sponsored agencies with a carrying value of $14.8 million were sold. The gross realized losses on such sales totaled $0.2 million. These funds along with cash on hand were used to repay the $25.0 million senior notes.

As of December 31, 2004, held-to-maturity investments with a carrying value of approximately $30.6 million were pledged as collateral for its $25.0 million senior notes. Collateral was limited to U.S. government and agency securities with a margined value of not less than 100.0 percent of the loan and was invested in accordance with the note agreement.

NASD INVESTOR EDUCATION FOUNDATION

Available-for-Sale Investments

The Foundation's investments include only domestic mutual funds with a cost and fair market value of $30.0 million as of December 31, 2005, and a cost and fair market value of $10.2 million as of December 31, 2004. The Foundation had temporarily restricted investments as of December 31, 2005 of $5.9 million.

Other than Temporary Declines in Fair Market Value

For the year ended December 31, 2005, the Foundation recorded impairment charges of $0.5 million on its mutual fund. The impairment charge related to declines in the fair value of its investments that was judged to be other-than-temporary and is reflected in net realized investment gains in the consolidated statements of income.

8. FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company considers cash and cash equivalents, receivables, investments, the note and revolving credit facility receivables from Amex, accounts payable and accrued expenses, accrued personnel costs, due to custodial agent, short- and long-term debt, and warrants to purchase NASDAQ common stock from NASD to be its financial instruments. The carrying amounts reported in the balance sheets for these financial instruments equal or closely approximate fair value due to the short-term nature of these assets and liabilities. The initial fair value of the revolving credit facility receivable from Amex and the fair value of the warrants to purchase NASDAQ common stock from NASD were determined based on third-party valuations.

The approximate fair value of NASDAQ's total debt was estimated using discounted cash flow analyses, based on NASDAQ's assumed incremental borrowing rates for similar types of debt arrangements and a Black-Scholes valuation technique was utilized to calculate the convertible option value for the convertible notes. As of December 31, 2005, the carrying value of NASDAQ's debt obligations was approximately $730.4 million less than fair value due to the stock appreciation on the convertible option feature from $14.50 at time of issuance to $35.18 at December 31, 2005. At December 31, 2004, the fair value of these obligations approximates their carrying amounts.

NASD 2005 Notes to Consolidated Financial Statements

9. LONG-TERM DEBT

NASD CREDIT FACILITY

In September 1999, NASD entered into an unsecured line of credit agreement. Under this agreement, NASD has the option to borrow up to $50.0 million at the London Inter-Bank Offered Rate (LIBOR) plus 0.3 percent. As of December 31, 2005 and 2004, no amounts were outstanding under this line of credit. The latest amendment to this line of credit agreement expires on November 30, 2006.

NASDAQ

The following table summarizes NASDAQ's debt obligations:

	DECEMBER 31,	
	2005	2004
	(in thousands)	
Senior notes	$ 750,000	$ 25,000
Convertible notes (net of premium and discount)	442,428	240,000
Total debt obligations	1,192,428	265,000
Less current portion	(7,500)	–
Total long-term debt obligations	$ 1,184,928	$ 265,000

Senior Notes

In order to finance the INET transaction, NASDAQ entered into a credit agreement dated as of December 8, 2005, with J.P. Morgan Securities, Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated acting as co-lead arrangers and joint bookrunners. The credit agreement provides for up to $825.0 million of senior secured financing. The $825.0 million available under the credit agreement includes (1) a five-year $75.0 million revolving credit facility, with a letter of credit sub-facility and swingline loan sub-facility, and (2) a six-year $750.0 million senior-term loan facility. The interest rate on loans made under the revolving credit facility varies depending upon NASDAQ's leverage ratio and LIBOR, and the interest rate on NASDAQ's senior term facility is LIBOR plus 150 basis points. Accordingly, the interest rate will vary over time. On December 8, 2005, NASDAQ drew the full $750.0 million senior-term debt. As of December 31, 2005, NASDAQ had not drawn any funds under the revolving credit facility. As of December 31, 2005, borrowings under the $750.0 million senior term debt bore interest at an average rate of 6.14 percent per annum. NASDAQ pays customary fees and expenses related to the credit facility, including a commitment fee of 0.5 percent per annum on the average daily unused portion of the revolving credit facility Interest expensed and paid on the $750.0 million senior term debt totaled approximately $3.1 million and $0.8 million, respectively, for the year ended December 31, 2005.

NASDAQ's obligations under the credit facility are secured by a security interest in and liens upon substantially all of the assets of NASDAQ and its subsidiaries. All NASDAQ's domestic subsidiaries are guarantors of NASDAQ's obligations under the credit agreement (excluding the regulated broker-dealer subsidiaries and the insurance-related subsidiaries).

The credit agreement contains customary covenants that restrict NASDAQ's ability to take on new debt, sell assets, issue stock, make loans and declare dividends. The credit agreement also requires NASDAQ to maintain a minimum interest expense coverage ratio and a maximum leverage ratio. The credit agreement also contains customary events of default, as well as cross-defaults with the convertible notes, as discussed below, and described fully in the credit agreement.

NASD 2005 Notes to Consolidated Financial Statements

9. LONG-TERM DEBT (CONTINUED)

Upon consummation of the INET transaction, and in conjunction with the issuance of the $750.0 million senior-term debt, NASDAQ was obligated to repay in full the $25.0 million senior notes. On November 30, 2005, NASDAQ repaid in full the $25.0 million senior notes and paid and recorded a loss on the early extinguishment of the $25.0 million senior notes of approximately $1.1 million and used proceeds from the sale of held-to-maturity investments and cash on hand to finance the redemption. The $25.0 million senior notes were issued in May 1997 and were to mature in 2012. These notes required monthly interest payments through May 2007 at an annual rate of 7.41 percent. After May 2007, NASDAQ would have incurred interest equal to the lender's cost of funds rate, as defined in the agreement, plus 0.5 percent. Interest expensed and paid on the $25.0 million senior notes totaled approximately $1.7 million and $1.9 million, respectively, for the year ended December 31, 2005 and totaled approximately $1.9 million for the year ended December 31, 2004.

In conjunction with the financing of the INET transaction, NASDAQ incurred debt issuance costs of $15.0 million. These debt issue costs related to the $75.0 million credit facility, the $205.0 million convertible notes and the restructuring of the $240.0 million convertible notes. These costs were capitalized and are included in other assets in the consolidated balance sheets and are being amortized over the life of each debt obligation. Beginning December 8, 2005, NASDAQ began amortizing these costs and recorded $0.2 million as additional interest expense in the consolidated statements of income.

Convertible Notes

In order to finance the INET transaction, NASDAQ also issued $205.0 million convertible notes to affiliates of Silver Lake Partners (SLP) ($145.0 million) and Hellman & Friedman (H&F) ($60.0 million) on April 22, 2005. The $205.0 million convertible notes, which were issued at a discount of $4.5 million, carry a coupon of 3.75 percent and will be convertible into NASDAQ common stock at a price of $14.50 per share or 14,137,931 shares subject to adjustment, in general, for any stock split, dividend, combination, recapitalization, or similar event. The $205.0 million convertible notes are being amortized over 7.5 years to face value. In 2005, NASDAQ recorded accretion of $0.4 million, which is recorded as interest expense in the consolidated statements of income. SLP and H&F also received 1.56 and 0.65 million warrants, respectively, to purchase NASDAQ common stock at a price of $14.50. The warrants cannot be exercised on or before April 22, 2006 and expire on December 8, 2008, the third anniversary of the closing of the INET acquisition. The cash received from the issuance of the $205.0 million convertible notes was held in a restricted cash account until the closing of the acquisition. NASDAQ earned interest income on this cash account of approximately $4.4 million in 2005 and interest expensed and paid totaled approximately $5.3 million and $4.8 million, respectively, for the year ended December 31, 2005.

In order to facilitate the transaction, H&F also restructured the terms of NASDAQ's original convertible $240.0 million subordinated notes, extending the maturity date from May 2006 to October 2012, lowering the interest coupon rate to 3.75 percent from 4.0 percent and lowering the conversion price to $14.50 from $20.00 or 16,551,724 shares, subject to adjustment, for stock splits, dividends, combinations, recapitalizations, or similar events. The $240.0 million convertible notes were issued at a premium of $1.6 million and are being amortized over 7.5 years to face value. In 2005, NASDAQ recorded accretion of $0.1 million, which was recorded as a reduction to interest expense in the consolidated statements of income. H&F also received an additional 2.75 million warrants to purchase NASDAQ common stock at a price of $14.50 per share. These warrants also cannot be exercised on or before April 22, 2006 and will expire on December 8, 2008, the third anniversary of the acquisition closing date. In accordance with EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," a substantial modification of terms should be accounted for and reported in the same manner as an extinguishment of debt. NASDAQ considered the modification of the terms of NASDAQ's original convertible $240.0 million subordinated notes to be substantial and therefore recorded a pre-tax

9. LONG-TERM DEBT (CONTINUED)

charge of $7.4 million related to the restructuring of the $240.0 million convertible notes. The pre-tax charge is included in general and administrative expense in the consolidated statements of income for the year ended December 31, 2005. Interest expensed and paid on the $240.0 million convertible notes totaled approximately $6.2 million and $4.5 million, respectively, for the year ended December 31, 2005. Interest expensed and paid on the $240.0 million subordinated notes totaled $3.0 million and $3.4 million, respectively, for the year ended December 31, 2005 and totaled $9.6 million for 2004.

On an as-converted basis at December 31, 2005, H&F owned an approximate 22.9 percent equity interest in NASDAQ as a result of H&F's ownership of the $240.0 million convertible notes, $60.0 million of the $205.0 million convertible notes, 3,400,000 shares underlying warrants and 500,000 shares of common stock purchased from NASDAQ in a separate transaction. On an as-converted basis at December 31, 2005, SLP owned an approximate 12.2 percent equity interest in NASDAQ as a result of SLP's ownership of $145.0 million of the $205.0 million convertible notes and 1,562,500 shares underlying warrants.

Both the $205.0 million convertible notes and $240.0 million convertible notes are senior unsecured obligations of NASDAQ and rank pari passu in right of payment with all existing and any future senior unsecured indebtedness of NASDAQ, are senior in right of payment to any future subordinated indebtedness of NASDAQ and are junior in right of payment to any senior secured indebtedness. The indenture governing the notes limits NASDAQ's ability to incur senior secured indebtedness and is limited to the $750.0 million senior-term debt and $75.0 million five-year revolving credit facility that was used to finance the INET acquisition, the $25.0 million senior notes and any future senior secured indebtedness provided that at the time of incurrence, NASDAQ maintains a ratio of aggregate senior secured indebtedness to EBITDA (as defined in the indenture) for the most recent four consecutive quarters of not greater than 4.0 to 1.0.

If a default under one or more of these financial agreements causes amounts outstanding under the applicable financial agreement or agreements to be declared to be immediately due and payable, NASDAQ will be required to expend the funds to pay such amounts. If NASDAQ does not have sufficient available cash to pay all amounts that become due and payable, NASDAQ would have to seek additional debt or equity financing, which may not be available on acceptable terms, or at all.

Before the restructuring of H&F's $240.0 million convertible notes, NASDAQ's original convertible $240.0 million subordinated notes held by H&F did not contain any financial maintenance covenants, but a default under any outstanding financing agreement that would have resulted in the acceleration of any debt having a principal amount in excess of $50.0 million would have caused a cross default under the $240.0 million subordinated notes.

At December 31, 2005 and 2004, NASDAQ was in compliance with the covenants of all debt agreements.

10. INCOME TAXES

NASD

As of December 31, 2005 and 2004, NASD Holding had net operating loss carryforwards of $105.6 million, which begin to expire in 2020. As of December 31, 2005 and 2004, NASD had unrelated business loss carryforwards of $28.0 million and $21.2 million, respectively, primarily related to TRACE, ADF and the OTC Equities. The unrelated business losses expire in 2006 through 2025.

Under SFAS No. 109, to record a deferred tax asset without a valuation allowance, it must be more likely than not that the deferred tax asset will be realized. NASD does not believe the net operating loss and unrelated business loss carryforwards will be realized. Therefore, a full valuation allowance has been recorded as of December 31, 2005 and 2004.

NASD 2005 Notes to Consolidated Financial Statements

10. INCOME TAXES (CONTINUED)

NASDAQ

The income tax provision (benefit) from continuing operations includes the following amounts, which relate to NASDAQ:

	YEARS ENDED DECEMBER 31,	
	2005	2004
	(in thousands)	
Current income tax provision (benefit):		
Federal	$ 39,502	$ (24,741)
State	577	208
Foreign	554	3,908
Total current income taxes	40,633	(20,625)
Deferred income tax provision (benefit):		
Federal	(2,059)	22,506
State	5,998	68
Foreign	—	(1,200)
Total deferred income taxes	3,939	21,374
Total income tax provision (benefit)	$ 44,572	$ 749

Reconciliations of the statutory U.S. federal income tax provision (benefit) from continuing operations, based on the U.S federal statutory rate, to NASDAQ's actual income tax provision (benefit) from continuing operations for the years ended December 31, 2005 and 2004 are as follows:

	YEARS ENDED DECEMBER 31,	
	2005	2004
	(in thousands)	
Federal income tax provision (benefit) at the statutory rate	$ 37,192	$ 894
State income tax provision (benefit), net of federal effect	4,274	179
Change in valuation allowance	720	(1,051)
Foreign taxes	178	872
Tax preferred investments	(1,195)	(601)
Nondeductible expenses	2,560	926
Prior year tax payable	417	(496)
Other	426	26
Actual income tax provision (benefit)	$ 44,572	$ 749

NASD 2005 Notes to Consolidated Financial Statements

10. INCOME TAXES (CONTINUED)

The temporary differences give rise to NASDAQ's deferred tax assets and (liabilities), consisting of the following:

	DECEMBER 31,	
	2005	2004
	(in thousands)	
Deferred tax assets:		
Deferred revenues	$ 35,232	$ 33,217
Acquired net operating loss [1]	74,690	—
Foreign net operating loss	1,244	1,506
State net operating loss	1,395	4,911
Compensation and benefits	12,806	12,365
Lease reserves	8,634	14,022
Capital loss carryforwards	7,584	6,903
Strategic review charges	2,484	3,113
Provision for bad debts	6,144	—
Other	1,225	4,366
Gross deferred tax assets	151,438	80,403
Deferred tax liabilities:		
Depreciation	(6,811)	(2,591)
Software development costs	(18,542)	(26,923)
Amortization of acquired intangible assets	(69,664)	—
Other	(2,242)	(373)
Gross deferred tax liabilities	(97,259)	(29,887)
Net deferred taxes before valuation allowance	54,179	50,516
Valuation allowance	(8,149)	(7,429)
Net deferred tax assets	$ 46,030	$ 43,087

(1) NASDAQ recorded a non-current deferred tax asset of $74.7 million on the sale of Instinet's Institutional Brokerage division. NASDAQ and SLP have an agreement to share the deferred tax benefit on the sale of the Institutional Brokerage division. To the extent the $74.7 deferred tax benefit is realized, approximately $40.0 million will be paid to SLP. NASDAQ has recorded a liabilty for the SLP share of the tax benefits in other liabilities in the consolidated balance sheets.

Of the $77.3 million net operating losses, federal losses of $62.3 million will expire in 2025, state losses of $13 8 million will expire through 2025, foreign losses of $0.4 million will expire 2007 through 2012 and foreign losses of $0.8 million have no expiration date. Of the $7.6 million of capital loss carryforwards, $0.7 million will expire 2006 through 2008, $6.3 million will expire in 2009 and $0.6 million will expire in 2010.

10. INCOME TAXES (CONTINUED)

The change in the valuation allowance from December 31, 2004 to December 31, 2005 is as follows:

	(in thousands)
Balance December 31, 2004	$ (7,429)
Foreign net operating loss carryforwards	(39)
Capital loss carryforwards	(681)
Balance December 31, 2005	$ (8,149)

Not included in the deferred tax assets for the year ended December 31, 2005 is a capital loss carryforward of $15.8 million generated through discontinued operations. The carryforward will expire in 2008. NASDAQ believes that it is more likely than not that it will not realize a benefit on this asset, therefore, NASDAQ established a valuation allowance of $15.8 million.

The following represents the domestic and foreign components of income (loss) from continuing operations before income tax provision (benefit):

	YEARS ENDED DECEMBER 31,	
	2005	2004
	(in thousands)	
Domestic	$ 104,556	$ (1,122)
Foreign	1,706	3,675
Income (loss) before income tax provision (benefit)	$ 106,262	$ 2,553

In 2005, NASDAQ recorded an income tax benefit of $21.5 million primarily related to employee stock option exercises. The benefit was recorded to additional paid-in-capital in the consolidated balance sheets.

NASDAQ is subject to examination by federal, state, local and foreign tax authorities. NASDAQ regularly assesses the likelihood of additional assessments by each jurisdiction and has established tax reserves that we believe are adequate in relation to the potential for additional assessments. During 2005, NASDAQ settled a New York City audit with additional tax assessed of $1.2 million. This amount has been previously reserved and had no impact on 2005 net income. NASDAQ believes that the resolution of tax matters will not have a material effect on the firm's financial condition but may be material to the firm's operating results for a particular period and upon the effective tax rate for that period.

11. EMPLOYEE BENEFITS

As of December 31, 2005 and 2004, the Company provided three non-contributory defined benefit pension plans and one non-contributory post-retirement benefit plan (Post-Retirement Plan) for the benefit of eligible employees of its subsidiaries. The non-contributory defined benefit plans consist of a funded ERP plan and two unfunded SERP plans. The benefits are primarily based on years of service and the employees' average salary during the highest 60 consecutive months of employment. The Post-Retirement Plan represents a life insurance benefit available to eligible retired employees.

NASD 2005 Notes to Consolidated Financial Statements

11. EMPLOYEE BENEFITS (CONTINUED)

The investment policy and strategy of the plan assets, as established by the NASD Pension Plan Committee, is to provide for preservation of principal, both in nominal and real terms, in order to meet the long-term spending needs of the pension plan by investing assets per the target allocations stated below. Asset allocations are reviewed quarterly and adjusted, as appropriate, to remain within target allocations. The investment policy is reviewed on an annual basis, under the guidance of an investment consultant, to determine if the policy or asset allocation targets should be changed. The plan assets consisted of the following as of December 31:

	Target Allocation	2005	2004
Equity securities	45.0-75.0%	65.5%	65.5%
Debt securities and cash equivalents	10.0-40.0%	19.5	26.0
Other investment strategies	10.0-20.0%	15.0	8.5
Total		100.0%	100.0%

The expected long-term rate of return for the plan's total assets is based on the expected return of each of the above categories, weighted based on the current target allocation for each class. Equity securities are expected to return 8.5 percent to 10.5 percent over the long term, other investment strategies are anticipated to yield 8.0 percent to 9.5 percent, while cash and fixed income is expected to return between 6.0 percent and 6.5 percent. Based on historical experience, the committee expects that the plan's asset managers overall will provide a modest (1.0 percent per annum) premium to their respective market benchmark indexes.

NASD 2005 Notes to Consolidated Financial Statements

11. EMPLOYEE BENEFITS (CONTINUED)

NASD

The following table sets forth the plan's funded status and amounts recognized in the consolidated balance sheets at December 31:

	2005			2004		
	ERP	SERP	Total	ERP	SERP	Total
			(in thousands)			
Change in benefit obligation						
Benefit obligation at beginning of year	$ 178,524	$ 19,900	$ 198,424	$ 137,275	$ 9,598	$ 146,873
Service cost	16,308	4,503	20,811	12,756	3,498	16,254
Interest cost	10,127	1,412	11,539	8,705	929	9,634
Actuarial losses (gains)	128	6,175	6,303	6,828	(86)	6,742
Benefits paid	(7,203)	(1,788)	(8,991)	(8,816)	(1,432)	(10,248)
Loss due to change in discount rate	11,094	1,232	12,326	17,032	1,919	18,951
Change in retirement age assumption	4,456	–	4,456	–	5,474	5,474
Transfers from Amex	–	–	–	4,744	–	4,744
Benefit obligation at end of year	$ 213,434	$ 31,434	$ 244,868	$ 178,524	$ 19,900	$ 198,424
Change in plan assets						
Fair value of plan assets at beginning of year	79,547	–	79,547	68,429	–	68,429
Transfers from Amex	–	–	–	4,198	–	4,198
Actual return on plan assets	6,943	–	6,943	7,688	–	7,688
Company contributions	12,463	1,788	14,251	8,048	1,432	9,480
Benefits paid	(7,203)	(1,788)	(8,991)	(8,816)	(1,432)	(10,248)
Fair value of plan assets at end of year	91,750	–	91,750	79,547	–	79,547
Funded status of the plan (underfunded)	(121,684)	(31,434)	(153,118)	(98,977)	(19,900)	(118,877)
Unrecognized net actuarial loss	75,795	18,260	94,055	63,618	12,837	76,455
Unrecognized prior service cost	883	97	980	1,151	269	1,420
Unrecognized transition asset	(288)	–	(288)	(445)	–	(445)
Amount recognized to reflect minimum pension liability	–	(8,131)	(8,131)	–	(7,645)	(7,645)
Net accrued benefit cost	$ (45,294)	$ (21,208)	$ (66,502)	$ (34,653)	$ (14,439)	$ (49,092)
Accumulated benefit obligation	$ 123,594	$ 21,208	$ 144,802	$ 103,082	$ 14,439	$ 117,521
Weighted-average assumptions, as of December 31,						
Discount rate	5.5%	5.5%		5.75%	5.75%	
Expected return on plan assets	8.5	–		8.75	–	
Rate of compensation increase	5.5	4.0		5.5	4.0	

NASD 2005 Notes to Consolidated Financial Statements

11. EMPLOYEE BENEFITS (CONTINUED)

The components of the accrued benefit cost for NASD's defined benefit pension plans and post-retirement benefit plan as of December 31, 2005 and 2004, and the location of these amounts in the consolidated balance sheets, were as follows:

	DECEMBER 31,	
	2005	2004
	(in thousands)	
Current (included in accrued personnel and benefit costs):		
ERP	$ (31,844)	$ (12,463)
SERP	(4,209)	(180)
Total current	(36,053)	(12,643)
Non-current (included in accrued pension and other post-retirement benefit costs):		
ERP	(13,450)	(22,190)
SERP	(16,999)	(14,259)
Total non-current pension	(30,449)	(36,449)
Post-retirement plan	(301)	(383)
Total non-current	(30,750)	(36,832)
Accrued benefit costs	$ (66,803)	$ (49,475)

Pursuant to the provisions of SFAS No. 87, related to the SERP, intangible assets of $0.1 million and $0.3 million were recorded as of December 31, 2005 and 2004, respectively. In addition, as of December 31, 2005 and 2004, minimum pension liabilities of $8.0 million and $7.4 million, respectively, were recorded in the consolidated balance sheets.

	YEARS ENDED DECEMBER 31,	
	2005	2004
	(in thousands)	
Components of net periodic benefit cost:		
Service cost	$ 20,811	$ 16,254
Interest cost	11,539	9,634
Expected return on plan assets	(6,730)	(5,779)
Amortization of unrecognized transition asset	(157)	(157)
Recognized net actuarial losses	5,271	3,218
Prior service cost recognized	442	469
Benefit cost (included in compensation expense)	$ 31,176	$ 23,639

NASD 2005 Notes to Consolidated Financial Statements

11. EMPLOYEE BENEFITS (CONTINUED)

The plan is measured at the beginning of each fiscal year. NASD expects to contribute $31.8 million to the ERP plan in 2006 and $4.2 million to the SERP plan. In addition, NASD expects to make the following benefit payments to participants over the next ten fiscal years:

	ERP	SERP	Total
		(in thousands)	
Fiscal year ended			
2006	$ 7,844	$ 4,209	$ 12,053
2007	9,657	6,410	16,067
2008	10,387	1,222	11,609
2009	12,559	1,584	14,143
2010	13,777	13,471	27,248
2011 through 2015	104,883	26,138	131,021
Total	$ 159,107	$ 53,034	$ 212,141

NASD also maintains voluntary savings plans for eligible employees of its subsidiaries. Employees are immediately eligible to make contributions to the plan and are also eligible for an employer contribution match at an amount equal to 100 percent of the first 4 percent of eligible employee contributions. Eligible plan participants may also receive an additional discretionary match from NASD. Savings plan expense for 2005 and 2004 was $10.7 million and $9.4 million, respectively, and is included within compensation expense in the consolidated statements of income. The expense included a discretionary match totaling $3.2 million for 2005 and $2.8 million for 2004.

In April 2004, NASD established a deferred compensation plan for certain eligible employees under the provision of Section 457(b) of the IRC. Eligible employees may make contributions to the plan and NASD may, at its discretion, make additional contributions to the plan. The assets of this plan are maintained within an irrevocable rabbi trust. NASD consolidates this trust in accordance with EITF No. 97-14, "Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested." As of December 31, 2005, $1.3 million of investments and $1.3 million of amounts due to plan participants are included in the available-for-sale investments and accrued personnel costs, respectively, in the consolidated balance sheet, representing participant contributions to this plan. As of December 31, 2004, $0.5 million of investments and $0.5 million payables to plan participants are included in the available-for-sale investments and accrued personnel costs, respectively, in the consolidated balance sheet. As of December 31, 2005 and 2004, NASD made no additional contributions to this plan.

In December 2005, NASD fully funded its SERP obligation through an irrevocable rabbi trust. NASD consolidates this trust in accordance with EITF No. 97-14. As of December 31, 2005, $24.5 million of investments are included in cash and cash equivalents in the consolidated balance sheets, representing the amounts contributed by NASD.

On January 1, 2006, NASD established a new defined contribution SERP plan for senior officers of NASD. Annual contributions are made based on salary and a portion of incentive compensation. Contributions and earnings vest at the end of each third-year and are fully vested at the age of 62.

NASD 2005 Notes to Consolidated Financial Statements

11. EMPLOYEE BENEFITS (CONTINUED)

NASDAQ

As of December 31, 2005, NASDAQ was a participating employer in a noncontributory, defined-benefit pension plan that NASD sponsors for the benefit of its eligible employees and the eligible employees of its subsidiaries. Benefits are primarily based on years of service and the employees' career-average salary during employment, subject to a phase-in period.

As part of NASDAQ's separation from NASD, effective January 1, 2006, NASDAQ adopted its own contributory, defined pension plan and transferred NASDAQ participants in NASD's pension plan to its pension plan. NASDAQ's adoption of a new plan did not have an impact on its consolidated financial position or results of operations.

Until November 1, 2003, NASDAQ participated in a SERP that was maintained by NASD for certain senior executives. On November 1, 2003, NASDAQ formed its own SERP and transferred all amounts to this new plan.

During 2003, NASDAQ also changed the accrual of benefits from age 65 to 10 years of service or age 55, whichever comes first, except in the case of an executive who has a contract with a SERP provision, then benefits are accrued in accordance with the contract terms.

NASD 2005 Notes to Consolidated Financial Statements

11. EMPLOYEE BENEFITS (CONTINUED)

The following table sets forth the ERP and SERP plans funded status as of December 31:

	2005			2004		
	ERP	SERP	Total	ERP	SERP	Total
			(in thousands)			
Change in benefit obligation						
Benefit obligation at beginning of year	$ 57,366	$ 16,135	$ 73,501	$ 60,961	$ 18,881	$ 79,842
Service cost	4,555	1,739	6,294	5,106	1,361	6,467
Interest cost	3,093	965	4,058	3,440	921	4,361
Actuarial (gains) losses	(2,802)	1,253	(1,549)	(5,659)	(499)	(6,158)
Benefits paid	(7,924)	(580)	(8,504)	(9,215)	(4,984)	(14,199)
Loss due to change in discount rate	–	–	–	5,922	455	6,377
Change in salary scale	–	–	–	(3,189)	–	(3,189)
Change in mortality rate	1,214	–	1,214	–	–	–
Benefit obligation at end of year	$ 55,502	$ 19,512	$ 75,014	$ 57,366	$ 16,135	$ 73,501
Change in plan assets						
Fair value of plan assets at beginning of year	32,284	–	32,284	32,988	–	32,988
Actual return on plan assets	(471)	–	(471)	2,467	–	2,467
Company contributions	8,936	580	9,516	6,044	4,984	11,028
Benefits paid	(7,924)	(580)	(8,504)	(9,215)	(4,984)	(14,199)
Fair value of plan assets at end of year	32,825	–	32,825	32,284	–	32,284
Funded status of the plan (underfunded)	(22,677)	(19,512)	(42,189)	(25,082)	(16,135)	(41,217)
Unrecognized net actuarial loss	19,336	4,099	23,435	18,754	3,545	22,299
Unrecognized prior service cost	(7,457)	(56)	(7,513)	(8,100)	318	(7,782)
Unrecognized transition asset	(106)	–	(106)	(164)	–	(164)
Amount recognized to reflect minimum pension liability	–	(3,814)	(3,814)	–	(3,360)	(3,360)
Net accrued benefit cost	$ (10,904)	$ (19,283)	$ (30,187)	$ (14,592)	$ (15,632)	$ (30,224)
Accumulated benefit obligation	$ 42,817	$ 19,283	$ 62,100	$ 43,011	$ 15,632	$ 58,643
Weighted-average assumptions, as of December 31,						
Discount rate	5.75%	5.75%		5.75%	5.75%	
Expected return on plan assets	8.50	–		8.75	–	
Rate of compensation increase	4.5	4.0		4.5	4.0	

NASD 2005 Notes to Consolidated Financial Statements

11. EMPLOYEE BENEFITS (CONTINUED)

The components of the accrued benefit cost for NASDAQ's defined benefit pension plans and post-retirement benefit plan as of December 31, 2005 and 2004, and the location of these amounts in the consolidated balance sheets, were as follows:

	DECEMBER 31,	
	2005	2004
	(in thousands)	
Current (included in accrued personnel and benefit costs):		
ERP	$ (5,119)	$ (8,935)
SERP	(7,167)	(571)
Total current	(12,286)	(9,506)
Non-current (included in accrued pension and other post-retirement benefit costs):		
ERP	(5,785)	(5,657)
SERP	(12,116)	(15,061)
Total non-current pension	(17,901)	(20,718)
Post-retirement plan	(405)	(244)
Total non-current	(18,306)	(20,962)
Accrued benefit costs	$ (30,592)	$ (30,468)

The following table sets forth the combined plans' amounts recognized in the consolidated statements of income:

	YEARS ENDED DECEMBER 31,	
	2005	2004
	(in thousands)	
Components of net periodic benefit cost:		
Service cost	$ 6,294	$ 6,467
Interest cost	4,057	4,361
Expected return on plan assets	(2,655)	(2,974)
Amortization of unrecognized transition asset	(57)	(58)
Recognized net actuarial losses	1,655	902
Prior service cost recognized	(270)	(319)
Curtailment/settlement loss recognized	—	207
Benefit cost (included in compensation expense)	$ 9,024	$ 8,586

The ERP and SERP plans are measured at the beginning of each fiscal year. Based on the current Internal Revenue Service regulations, NASDAQ expects to contribute approximately $5.1 million to the ERP plan and $7.2 million to the SERP plan in 2006. This includes $1.2 million for the 2005 plan year contribution and $3.9 million for the 2006 plan year. The SERP is an unfunded plan.

11. EMPLOYEE BENEFITS (CONTINUED)

NASDAQ expects to make the following benefit payments to participants in the next ten fiscal years:

	ERP	SERP	Total
		(in thousands)	
Fiscal year ended			
2006	$ 2,965	$ 7,167	$ 10,132
2007	2,754	4,192	6,946
2008	3,494	761	4,255
2009	3,488	747	4,235
2010	3,232	733	3,965
2011 through 2015	25,958	5,284	31,242
	$ 41,891	$ 18,884	$ 60,775

During 2004, there were settlement losses of $0.2 million for employees included within the SERP plan due to early retirements. There were no settlement losses in 2005.

Beginning in 2001, pursuant to the provisions of SFAS 87, "Employers' Accounting for Pensions" related to the SERP, NASDAQ recorded an intangible asset and an adjustment to stockholders' equity to recognize the minimum pension liability. During 2004, the intangible asset and the minimum pension liability were adjusted to $0.3 million and $1.8 million (net of tax of $1.2 million), respectively. As of December 31, 2005, the intangible asset was reduced to zero and the minimum pension liability was $2.3 million (net of tax of $1.5 million).

Prior to April 1, 2002, NASDAQ participated in a voluntary savings plan for eligible employees of NASD and its subsidiaries. As of April 1, 2002, NASDAQ formed its own voluntary savings plan and all amounts were transferred to this new plan. This voluntary savings plan is a defined-contribution plan. Employees are immediately eligible to make contributions to the plan and are also eligible for an employer contribution match at an amount equal to 100.0 percent of the first 4.0 percent of eligible employee contributions. Eligible plan participants may also receive an additional discretionary match from NASDAQ; however, there was no discretionary match for 2005 and 2004. Savings plan expense included in compensation and benefits expense in the consolidated statements of income for the years ended December 31, 2005 and 2004 was $2.7 million and $3.1 million, respectively.

12. NASDAQ STOCK COMPENSATION, STOCK AWARDS AND CAPITAL STOCK

Effective December 5, 2000, as amended on February 14, 2001 and January 23, 2002, NASDAQ adopted The Nasdaq Stock Market, Inc. Equity Incentive Plan (the "Plan"), under which nonqualified and qualified incentive stock options, restricted stock, restricted stock units or other stock based awards may be granted to employees, directors, officers and consultants. A total of 24,500,000 shares are authorized under the Plan. As of December 31, 2005, 8,090,874 shares were available for future grants under the Plan. In 2005 and 2004, there were no issuances outside of the Plan.

In 2005, NASDAQ granted 439,650 stock options to employees and officers, 305,000 shares of restricted stock to employees and officers and 25,756 shares of restricted stock to non-employee directors under the Plan. During 2005, 788,213 stock options and 64,353 shares of restricted stock awards were forfeited.

12. NASDAQ STOCK COMPENSATION, STOCK AWARDS AND CAPITAL STOCK (CONTINUED)

In November 2002, the NASDAQ's Board of Directors approved a modification to the Non-Employee Directors Compensation Policy to allow non-employee directors to receive a compensation package valued at $40,000. Later, on April 28, 2004, NASDAQ's Board of Directors approved a modification to the Non-Employee Directors Compensation Policy whereby all non-employee directors would receive a base compensation package valued at $50,000. Each non-employee director may elect to receive the base compensation package in cash, payable in equal quarterly installments, shares of restricted stock or a combination of cash and restricted stock. The shares of restricted stock will vest two years from the date of grant and unvested shares are forfeited in certain circumstances upon termination of the director's service on the NASDAQ Board. During 2005, 25,756 shares of restricted stock were awarded to non-employee directors. Directors who serve as committee chairs or as members of the Audit Committee and the chairman of the board are entitled to additional compensation beyond the base compensation package. These additional amounts are paid in cash rather than restricted stock.

Restricted stock awards are awarded in the name of the employee or officer at fair market value on the date of the grant. In 2005, NASDAQ granted 305,000 shares of restricted stock to employees and officers with a weighted-average grant price of $17.70. Restricted stock awards contain restrictions on sales and transfers, are generally subject to a five-year vesting period and are expensed over the vesting period. Beginning in 2005, NASDAQ also granted performance based restricted stock awards. The number of awards that vest is based on meeting certain performance conditions. NASDAQ recognized $1.4 million and $0.5 million in amortization expense related to restricted stock during the years ended December 31, 2005 and December 31, 2004, respectively.

Stock options are granted with an exercise price equal to the fair market value of the stock on the date of the grant. NASDAQ accounts for stock option grants in accordance with APB No. 25 and, accordingly, recognizes no compensation expense related to such grants.

Options granted generally vest over three years and expire 10 years from the date of grant. Beginning in 2004, the NASDAQ Board of Directors approved the issuance of Performance Accelerated Stock Options (PASO) and granted 4,919,000 PASOs during 2004 and an additional 52,500 in 2005. The PASOs include a performance-based accelerated vesting feature based on NASDAQ achieving specific levels of performance in fiscal years 2004 and 2005. The vestings of the PASO awards are no longer than six years from the grant date. All options to date have been granted at fair market value on the date of grant. As of December 31, 2005, options for 5,316,755 shares were vested (including grants outside of the Plan), and exercisable with a weighted-average exercise price of $10.30. As of December 31, 2004, options for 8,368,901 shares were vested (including grants outside of the Plan), and exercisable with a weighted-average exercise price of $11.92. The weighted-average remaining contract life was 7.2 years and 7.6 years at December 31, 2005 and 2004, respectively.

NASD 2005 Notes to Consolidated Financial Statements

12. NASDAQ STOCK COMPENSATION, STOCK AWARDS AND CAPITAL STOCK (CONTINUED)

Stock option activity, including shares from outside of the Plan, during the year ended December 31, 2005, is summarized below:

		PRICE PER SHARE	
	Shares	Range	Weighted-Average
Balance, January 1, 2005	17,056,763	$ 5.28 — $ 19.70	$ 9.75
Granted	439,650	$ 8.30 — $ 42.28	$ 20.59
Exercised	4,131,058	$ 6.55 — $ 19.70	$ 12.48
Canceled	1,253,252	$ 6.15 — $ 25.96	$ 9.46
Balance, December 31, 2005	12,112,103	$ 5.28 — $ 42.28	$ 9.23

The following table presents the options outstanding as of December 31, 2005, by range of exercise prices:

Range of Exercise Prices	Outstanding as of December 31, 2005	Weighted-Average Exercise Price
$ 5.28 — $ 7.34	2,360,050	$ 5.99
$ 7.35 — $ 8.49	3,696,075	$ 7.38
$ 8.50 — $ 10.24	2,830,966	$ 8.77
$ 10.25 — $ 12.99	140,880	$ 10.44
$ 13.00 — $ 13.38	2,724,432	$ 13.00
$ 13.39 — $ 19.69	54,300	$ 16.06
$ 19.70 — $ 25.01	127,300	$ 21.08
$ 25.02 — $ 30.09	117,450	$ 25.95
$ 30 10 — $ 36.07	39,900	$ 31.00
$ 36.08 — $ 42.28	20,750	$ 41.56
	12,112,103	$ 9.23

Stock option activity, including shares from outside of the Plan, during the year ended December 31, 2004 is summarized below:

		PRICE PER SHARE	
	Shares	Range	Weighted-Average
Balance, January 1, 2004	13,423,134	$ 5.28 — $ 19.70	$ 10.82
Granted	6,068,800	$ 6.15 — $ 9.15	$ 7.58
Exercised	310,296	$ 5.28 — $ 8.50	$ 5.39
Canceled	2,124,875	$ 6.15 — $ 13.00	$ 10.94
Balance, December 31, 2004	17,056,763	$ 5.28 — $ 19.70	$ 9.75

NASDAQ has an employee stock purchase plan for all eligible employees. Under the plan, shares of common stock may be purchased at six-month intervals (each, an offering period) at 85.0 percent of the lower of the fair market value on the first or the

12. NASDAQ STOCK COMPENSATION, STOCK AWARDS AND CAPITAL STOCK (CONTINUED)

last day of each offering period. Employees may purchase shares having a value not exceeding 10.0 percent of their annual compensation, subject to applicable annual Internal Revenue Service limitations. During 2005 and 2004, employees purchased an aggregate of 106,437 and 110,408 shares at a weighted-average price of $11.29 and $5.45 per share, respectively.

Pro forma information regarding net income is required under SFAS No. 148 and has been determined as if NASDAQ had accounted for all stock option grants based on a fair value method. The fair value of each stock option grant was estimated at the date of grant using the Black-Scholes valuation model assuming a weighted-average expected life of five years, weighted-average expected volatility of 30.0 percent and a weighted-average risk-free interest rate of 4.05 percent and 3.43 percent for 2005 and 2004, respectively. The weighted-average fair value of options granted in 2005 and 2004 was $7.05 and $2.49, respectively.

Pro forma net income includes the amortization of the fair value of stock options over the vesting period and the difference between the fair value and the purchase price of common shares purchased by employees under the employee stock purchase plan. The pro forma net income also includes a reduction in option expense due to the true-up of actual forfeitures. The pro forma information for the years ended December 31, 2005 and 2004 is as follows:

	2005	2004
	(in thousands)	
Income from continuing operations	$ 293,715	$ 105,135
Compensation expense (net of minority interest of $2,639 in 2005 and $1,784 in 2004)	(1,107)	(2,152)
Pro forma income from continuing operations	$ 292,608	$ 102,983

13. LEASES

NASD

NASD leases certain office space and equipment in connection with its operations. The majority of these leases contain escalation clauses based on increases in property taxes and building operating costs. Certain of these leases also contain renewal options. Rent expense for operating leases was $21.8 million in 2005 and $21.6 million in 2004, and is included in occupancy expense in the consolidated statements of income.

Future minimum lease payments under non-cancelable operating leases with initial or remaining terms of one year or more consisted of the following at December 31, 2005:

	(in thousands)
Year ending December 31,	
2006	$ 19,104
2007	17,428
2008	17,151
2009	16,640
2010	16,497
Remaining years	116,000
Total minimum lease payments	$ 202,820

13. LEASES (CONTINUED)

Future minimum lease payments under non-cancelable capital leases with initial or remaining terms of one year or more consisted of the following at December 31, 2005:

	(in thousands)
Year ending December 31,	
2006	$868
2007	88
Total minimum lease payments	956
Less: imputed interest	(10)
Total present value of minimum lease payments	$946

NASDAQ

NASDAQ leases office space and equipment under non-cancelable operating leases with third parties and also subleases office space from NASD in New York City. Some of NASDAQ's leases contain renewal options and escalation clauses based on increases in property taxes and building operating costs.

As of December 31, 2005, future minimum lease payments under non-cancelable operating leases (net of sublease income) are as follows:

	Gross Lease Commitment	Sublease Income	Net Lease Commitment
		(in thousands)	
Year ending December 31,			
2006	$ 35,938	$ 2,691	$ 33,247
2007	27,450	2,729	24,721
2008	22,556	2,804	19,752
2009	21,705	2,771	18,934
2010	20,866	2,432	18,434
Remaining years	135,475	12,957	122,518
Total minimum lease payments	$ 263,990	$ 26,384	$ 237,606

Rent expense for operating leases (net of sublease income of $2.2 million and $0.4 in 2005 and 2004, respectively) was $18.5 million and $18.3 million for the years ended December 31, 2005 and 2004, respectively.

In October 2004, NASDAQ entered into an agreement for technology equipment and also renegotiated related operating leases with a major vendor. NASDAQ also entered into a three-year lease agreement, which included new upgraded equipment. The future minimum lease payments associated with these agreements are included in the table above.

NASD 2005 Notes to Consolidated Financial Statements

14. COMMITMENTS AND CONTINGENCIES (CONTINUED)

NASD

EDS

On April 1, 2003, NASD and EDS entered into a service agreement (2003 EDS Agreement) that superseded an existing agreement with NASD. The 2003 EDS Agreement expires on December 31, 2012. Under the 2003 EDS Agreement, NASD was obligated to pay EDS a minimum of $24.0 million for the first year, (prorated for a nine-month period during 2003 commencing on the effective date), which is reduced ratably to $16.0 million in the final year for both applications development and maintenance services. NASD is also required to use EDS for all its production services needs. As consideration for the 2003 EDS Agreement, NASD agreed to forgive a $35.3 million deposit with EDS related to the previous EDS agreement. This deposit is being amortized on a straight-line basis over the remaining term of the 2003 EDS Agreement. As of December 31, 2005 and 2004, NASD recorded other assets of $25.4 million and $29.0 million, respectively, representing the unamortized balance of the deposit with EDS. Amortization expense of $3.6 million was recorded during both years ended December 31, 2005 and 2004, respectively, and is included within depreciation and amortization in the consolidated statements of income.

New York City

In 2001, NASD entered into a series of incentive agreements with the City of New York resulting in potential incentives aggregating $53.6 million on a net present value basis to NASD, NASDAQ and Amex. The terms of this agreement required NASD, NASDAQ and Amex together to maintain a set number of full-time employees within New York City annually until December 31, 2020. If NASD does not meet the required headcount, it will be required to pay back either all or a portion of the benefits recognized. In 2004, NASD amended this agreement to separate the benefits among NASD, NASDAQ and Amex individually. As of December 31, 2005, NASD met the headcount requirements as stipulated in the agreement.

New York State Grant

In April 2003, NASD received $3.0 million of a capital grant from the New York State Urban Development Corporation d/b/a Empire State Development Corporation (ESDC). The terms of this grant required NASD, NASDAQ and Amex together to maintain a set number of full-time employees within New York City annually until January 1, 2009. If the required headcount as summarized in this grant are not maintained, NASD, NASDAQ and Amex will be required to pay back to ESDC either all or a portion of the grant received. In 2004, NASD amended this agreement to separate the benefits among NASD, NASDAQ and Amex individually. As of December 31, 2005, NASD met the headcount requirements as stipulated in the agreement.

Series 7 Exam

On January 6, 2006, NASD announced that 1,882 individuals who took the Series 7 broker qualification exam between October 1, 2004 and December 20, 2005, incorrectly received a failing grade due to a software error. This error caused some test takers to score just below the minimum passing grade. As of April 19, 2006, there are 10 class action cases and one individual case pending in federal courts in the District of Columbia, New York, Ohio and Arkansas. NASD has requested the Judicial Panel on Multidistrict Litigation (MDL Panel) to consolidate these cases in the Southern District of New York. A hearing on NASD's motion will be heard on May 25, 2006. Most of these cases are stayed pending action by the MDL Panel. At this time, NASD is not able to reasonably estimate a potential loss on these lawsuits or any additional unasserted claims. As a result, no accrual has been recorded in accordance with SFAS No. 5, "Accounting for Contingencies," other than $1.6 million accrued as of December 31, 2005,

14. COMMITMENTS AND CONTINGENCIES (CONTINUED)

representing estimated refunds for exam fees and travel costs for those who incorrectly failed the exam. This amount is included in other current liabilities in the consolidated balance sheets.

NASDAQ

Acquisition of Instinet Group

As a result of the acquisition of Instinet, NASDAQ amended the original execution and clearing services agreement between INET and ICS, an affiliate of SLP. Under this amended agreement, ICS will provide INET with clearing and execution services for approximately $6.2 million for a period not to exceed six months, unless the parties agree otherwise.

Also as a result of the acquisition, NASDAQ entered into an agreement with a former affiliate of Instinet to have the former affiliate provide transition services for a period of up to six months after the closing date of the acquisition. Under this agreement, the former affiliate will provide INET with office space, and provide INET and NASDAQ with desktop support, finance support and access to the FIX engines and Smart routers. This agreement has a maximum fee of $0.2 million per month and could be lower depending on whether or not the services are provided. This agreement can be terminated early with a minimum of thirty days notice.

Brut Agreements

Brut contracted with a subsidiary of SunGard, SunGard Financial Systems Inc., for SunGard Financial to provide Brut online processing report services and related services in connection with Brut's clearance of trades. The term of this agreement is five years and began in September 2004, and is automatically renewed at yearly intervals thereafter until terminated by Brut or SunGard Financial. The annual service fee is $10.0 million in the first year, declining to $8.0 million in the second year, and $6.0 million in the third year of the agreement. The annual service fee is subject to price review in years four and five based on market rates, but will not be less than $4.0 million per year. Some additional fees may be assessed based on services needed or requested.

Brut also contracted with SunGard to host certain software on designated equipment at a SunGard facility for a transitional period beginning in September 2004. SunGard developed and operated the computer software programs that enable Brut to operate and provide order entry and execution over its ECN. Under the terms of the original agreement, which ran from September 2004 through May 2005, Brut was obligated to pay SunGard approximately $0.1 million per month. An amendment was signed on November 29, 2004, that extended the original agreement through June 30, 2006. Beginning November 30, 2005, Brut has the option to cancel the agreement within thirty days written notice to SunGard. An additional amendment, which was effective August 1, 2005, reduced the monthly payment to a nominal amount ($0.7 million in 2006) for the remainder of the term of the agreement, which now expires in December 2006. After May 1, 2006, Brut may cancel the agreement upon providing SunGard sixty days written notice.

Brokerage Activities

Brut and INET provide guarantees to securities clearinghouses and exchanges under standard membership agreements, which require members to guarantee the performance of other members. If a member becomes unable to satisfy its obligations to the clearinghouses, other members would be required to meet its shortfalls. To mitigate these performance risks, the exchanges and clearinghouses often require members to post collateral, as well as meet certain minimum financial standards. Brut's and INET's

14. COMMITMENTS AND CONTINGENCIES (CONTINUED)

maximum potential liability under these arrangements cannot be quantified. However, NASDAQ believes that the potential for Brut and INET to be required to make payments under these arrangements is unlikely. Accordingly, no contingent liability is recorded in the consolidated balance sheets for these arrangements. NASDAQ has received inquiries from NASD regarding compliance with Brut's obligations regarding short sales, firm quotes and other reporting and disclosure requirements. At this time, NASDAQ cannot estimate the amount of any potential fines or penalties associated with these matters, but NASDAQ does not believe that any potential fines or penalties would be significant.

GENERAL LITIGATION

The Company may be subject to claims arising out of the conduct of its business. Currently, there are certain legal proceedings pending against the Company. Management believes, based on the opinion of counsel, it has adequately provided for any liabilities or settlements arising from these proceedings. Management is not aware of any unasserted claims or assessments that would have a material adverse effect on the financial position and the results of operations of the Company.

15. DISCONTINUED OPERATIONS

AMEX

On December 31, 2004, NASD sold its Class B interest in Amex to Amex Membership Corporation. As a result of this transaction, NASD recognized a cumulative loss on sale of $225.0 million, of which $0.3 million and $6.8 million was recognized in 2005 and 2004, respectively. The remaining $217.9 loss on Amex was recognized as of December 31, 2003. Amex was previously reported by NASD as a separate segment under SFAS No. 131.

In accordance with SFAS No. 144, Amex is reflected as a discontinued operation. As a discontinued operation, the revenues, costs and expenses, and cash flows of Amex have been excluded from the respective captions in the consolidated statements of income and consolidated statements of cash flows, and have been presented separately as "income (loss) from discontinued operations, net of tax" and as "cash provided by (used in) discontinued operations." There were no assets and liabilities of Amex as of December 31, 2005 and 2004 included in the consolidated balance sheets.

As of December 31, 2005 and 2004, NASD had accrued liabilities of $5.6 million and $7.5 million, respectively, representing transaction and employee costs incurred as part of the sale agreement. These amounts are included in other current liabilities in the consolidated balance sheet.

The following table presents condensed results of operations for Amex for the year ended December 31, 2004.

	(in thousands)
Revenues	$ 218,258
Income from discontinued operations	$ 10,139

As part of the sale of Amex, NASD and Amex entered into several other agreements, including a term loan agreement for $25.0 million, a revolving credit facility for $25.0 million, a Transition Services Agreement, and a Regulatory Services Agreement. See Note 2, "Summary of Significant Accounting Policies," for additional information on the loan agreements.

NASD 2005 Notes to Consolidated Financial Statements

15. DISCONTINUED OPERATIONS (CONTINUED)

Under the Transition Services Agreement, NASD will provide certain administrative and other support services to Amex for a period of up to five years. The services to be provided by NASD include accounting, purchasing, internal audit and other administrative services. For the year ended December 31, 2005, NASD recognized $4.4 million of revenue, which is included in other revenue in the consolidated statements of income, from this agreement. For the year ended December 31, 2004, NASD recognized intercompany revenues of $5.4 million for administrative and other support services provided to Amex. These intercompany revenues have been eliminated in consolidation. As of December 31, 2005, Amex reintegrated all functions under this agreement into its operations and had provided NASD notification of its intent to terminate the internal audit service.

NASD provides certain regulatory services and develops certain regulatory technologies for Amex. If Amex requires additional services or technologies beyond the initially agreed scope of work, Amex is generally required to give NASD the opportunity to perform such additional services. Further, NASD may extend financing to Amex for the costs of technology and related matters that may be required to be implemented by the SEC, but NASD will not extend financing for any fines or penalties imposed on Amex by the SEC. For the year ended December 31, 2005, NASD recognized $20.1 million of revenue related to regulatory services provided to Amex and is included in contract service fees in the consolidated statements of income. For the year ended December 31, 2004, NASD recognized intercompany revenue of $6.6 million related to regulatory services provided to Amex. These intercompany revenues have been eliminated in consolidation.

NASDAQ EUROPE

On December 18, 2003, NASDAQ transferred its interest in NASDAQ Europe to one of that company's original investors for nominal cash consideration. In the fourth quarter of 2004, NASDAQ recognized a gain on the release of a reserve for potential claims against NASDAQ that management established at the time of the transfer of NASDAQ's shares of NASDAQ Europe. In the fourth quarter of 2004, Easdaq reached agreements with certain of its creditors to settle these creditors' existing claims against Easdaq. NASDAQ was the third-party beneficiary of these creditor agreements and released the $15.1 million reserve management established.

In accordance with SFAS No. 144, NASDAQ Europe is reflected as a discontinued operation. As a discontinued operation, the revenues, costs and expenses, and cash flows of NASDAQ Europe have been excluded from the respective captions in the consolidated statements of income and consolidated statements of cash flows and have been presented separately as "income (loss) from discontinued operations, net of tax" and as "cash provided by (used in) discontinued operations." There were no assets and liabilities of NASDAQ Europe at December 31, 2005 and 2004.

The following table presents condensed results of operations for NASDAQ Europe for the year ended December 31, 2004.

	(in thousands)
Revenues	$ –
Pre-tax income (loss)	15,154
(Provision) benefit for income taxes	(5,596)
Income (loss) from discontinued operations	$ 9,558

NASD 2005 Notes to Consolidated Financial Statements

16. BUSINESS SEGMENT INFORMATION

As described in Note 2, "Summary of Significant Accounting Policies," NASD operates in two business segments, NASD and NASDAQ. NASD includes NASD, NASDR and NASD DR. NASDAQ represents a separate identifiable organization. Transactions between segments are accounted for at fair value as if the transactions were to third parties. All inter-segment transactions have been eliminated in consolidation.

SEGMENT INCOME OR LOSS

The Company's accounting policies for segments are the same as those described in Note 2, "Summary of Significant Accounting Policies." Management evaluates segment performance based on net revenue less expenses. Consolidating adjustments represent the elimination of intercompany transactions.

	2005			
	NASD	NASDAQ	Consolidating Adjustments	Consolidated
	(in thousands)			
Revenues	$ 1,057,456	$ 879,919	$ (63,011)	$ 1,874,364
Cost of revenues	(413,483)	(353,908)	12,827	(754,564)
Net revenues	643,973	526,011	(50,184)	1,119,800
Total expenses	652,473	411,727	(48,830)	1,015,370
Net revenue less expenses	(8,500)	114,284	(1,354)	104,430
Total assets	2,418,249	2,046,738	(154,449)	4,310,538
Depreciation and amortization	37,555	66,986	–	104,541
Interest and dividend income	66,578	12,735	(6,596)	72,717
Purchases of property and equipment	$ 40,998	$ 25,402	$ (18,000)	$ 48,400

	2004			
	NASD	NASDAQ	Consolidating Adjustments	Consolidated
	(in thousands)			
Revenues	$ 872,653	$ 540,441	$ (71,777)	$ 1,341,317
Cost of revenues	(230,853)	(55,845)	–	(286,698)
Net revenues	641,800	484,596	(71,777)	1,054,619
Total expenses	569,342	476,413	(49,001)	996,754
Net revenue less expenses	72,458	8,183	(22,776)	57,865
Total assets	1,704,679	814,820	(164,781)	2,354,718
Depreciation and amortization	39,531	76,336	–	115,867
Interest and dividend income	42,682	5,854	(13,188)	35,348
Purchases of property and equipment	$ 28,526	$ 26,029	$ –	$ 54,555

NASD 2005 Notes to Consolidated Financial Statements

16. BUSINESS SEGMENT INFORMATION (CONTINUED)

GEOGRAPHIC DATA

The following table presents revenues and property and equipment, net by geographic area for 2005 and 2004. Revenues are classified based upon the location of the customer. Property and equipment information is based on the physical location of the assets.

	Revenues	Property and equipment, net
	(in thousands)	
2005:		
United States	$ 1,823,072	$ 268,816
All other countries	51,292	552
Total	$ 1,874,364	$ 269,368
2004:		
United States	$ 1,292,446	$ 313,088
All other countries	48,871	757
Total	$ 1,341,317	$ 313,845

INTER-SEGMENT TRANSACTIONS

Summarized below are significant inter-segment transactions between NASD and NASDAQ.

Surveillance and Other Regulatory Services

NASDR incurs costs associated with monitoring, legal and enforcement activities related to the regulation of NASDAQ. These costs are charged to NASDAQ based upon NASD management's estimated percentage of costs incurred by each NASDR department that are attributable directly to The NASDAQ Stock Market surveillance. Inter-segment charges from NASDR to NASDAQ for surveillance and other regulatory services were $41.7 million and $45.6 million for the years ended December 31, 2005 and 2004, respectively.

TRACE

NASDAQ Technology was established in 2004 and provides software, hosting and disaster recovery services to third parties. Effective November 1, 2004, NASDAQ Technology and NASD entered into a contract for technology development support services for a fixed income trade reporting platform, TRACE. Inter-segment charges were $3.9 million and $1.8 million for the years ended December 31, 2005 and 2004, respectively.

Transfer of the OTC Equities Business to NASD

On September 2, 2005, NASD executed the OTCBB and OTC Equities Revocation of Delegation and Asset Transfer and Services Agreement (OTC Equities Agreement) with NASDAQ related to the OTC Equities. The OTC Equities includes OTCBB and is an electronic screen-based quotation service for securities that, among other things, are not listed on The NASDAQ Stock Market or any U.S. national securities exchange. Under the OTC Equities Agreement, effective October 1, 2005, NASDAQ transferred

16. BUSINESS SEGMENT INFORMATION (CONTINUED)

responsibility for the OTC Equities back to NASD. This transfer is designed to address concerns expressed by the SEC regarding NASDAQ continuing to operate the OTC Equities after Exchange Registration. As consideration for this agreement, NASD has agreed to outsource the operation of the OTC Equities to NASDAQ for an initial two-year period, subject to one-year renewals upon mutual consent. NASD will pay NASDAQ $14.2 million in the first year and $14.7 million in the second year for NASDAQ's services under the OTC Equities Agreement, with payments in any subsequent periods to be subject to agreement between NASD and NASDAQ. Any enhancements directed by NASD to the OTC Equities system will be billed to NASD on a time and materials basis as described in the OTC Equities Agreement. Inter-segment charges from NASDAQ to NASD for OTC Equities were $3.8 million for the year ended December 31, 2005.

NASD and NASDAQ structured this transfer of the businesses to be seamless to the customers of the OTC Equities. The transfer was recorded at book value on October 1, 2005, as NASD and NASDAQ are entities under common control.

Sale of Building

In June 2005, NASDAQ completed the sale of the building it owned in Rockville, Maryland, located at 9513 Key West Avenue, to NASD for $18.0 million. This transaction has been eliminated in consolidation.

Preferred Stock

In March 2002, NASDAQ issued 1,338,402 shares of Series A Cumulative Preferred Stock and one share of Series B Preferred Stock to NASD. The Series A Cumulative Preferred Stock carried a 7.6 percent dividend rate for the year commencing March 2003, and carried a 10.6 percent dividend rate in all subsequent years. The Series B Preferred Stock does not pay dividends. On September 30, 2004, NASD waived a portion of the dividend for the third quarter of 2004 of $2.5 million and accepted an aggregate amount of $1.0 million (calculated based on an annual rate of 3.0 percent) as payment in full of the dividend for this period. On November 29, 2004, NASDAQ entered into an exchange agreement with NASD, pursuant to which NASD exchanged 1,338,402 shares of NASDAQ's Series A Cumulative Preferred Stock, representing all the outstanding shares of Series A Cumulative Preferred Stock, for 1,338,402 shares of newly issued Series C Cumulative Preferred Stock. The Series C Cumulative Preferred Stock accrues quarterly dividends at an annual rate of 3.0 percent for all periods until July 1, 2006, and at an annual rate of 10.6 percent for periods thereafter.

On April 21, 2005, NASD entered into a Stock Repurchase and Waiver Agreement with NASDAQ, whereby NASD consented to the financing used in connection with NASDAQ's acquisition of Instinet. In exchange for the waiver, NASDAQ repurchased 384,932 shares of its Series C Cumulative Preferred Stock owned by NASD for approximately $40.0 million. On December 20, 2005, NASD exchanged its one share of NASDAQ's Series B Preferred Stock for one newly issued share of Series D Preferred Stock, which had terms substantially similar to the terms of the Series B Preferred Stock..

The Series C Cumulative Preferred Stock was paid in full on February 15, 2006.

17. SUBSEQUENT EVENTS

NASDAQ Exchange Registration

On January 13, 2006, the SEC approved NASDAQ's application to operate as a national securities exchange. NASDAQ will begin operating as an exchange once it meets conditions imposed by the SEC. Upon effectiveness of Exchange Registration, NASDAQ will redeem the Series D Preferred Stock and NASD will no longer exert voting control over NASDAQ. As a result of the redemption of

17. SUBSEQUENT EVENTS (CONTINUED)

the Series D Preferred Stock, NASD will cease consolidating NASDAQ and will have reduced its ownership of NASDAQ to the number of shares underlying the unexercised warrants for Tranche IV.

NASDAQ's Acquisition of Shareholder.com

On February 6, 2006, NASDAQ completed the acquisition of Shareholder.com, a privately held, Massachusetts-based firm specializing in shareholder communications and investor relations intelligence services, for $40.0 million in cash, subject to post-closing adjustments. Shareholder.com will operate as a wholly owned subsidiary of NASDAQ. Shareholder.com currently serves over 1,000 clients, including companies listed on both domestic and foreign exchanges. Shareholder.com will continue to offer its comprehensive suite of services to all publicly held companies who wish to optimize investor relations capabilities.

Sales of NASDAQ Common Stock

On February 15, 2006, NASDAQ completed another common stock offering of 13,895,229 shares of its common stock. The offering consisted of 7,000,000 primary shares, 3,505,886 shares of NASDAQ's common stock offered by NASD, and 3,389,343 shares of NASDAQ common stock offered by other stockholders who received shares through the exercise of warrants they purchased in NASDAQ's 2000 and 2001 private placements. In addition, on February 15, 2006, NASDAQ redeemed all outstanding shares of Series C Cumulative Preferred Stock from NASD.

On March 2, 2006, the underwriters for NASDAQ's public offering exercised their option and purchased an additional 2,084,284 shares of common stock from NASD and NASDAQ. NASD and NASDAQ contributed equally to the over-allotment option. The completion of the offering, including the exercise of the over-allotment, resulted in a total sale of 15,979,513 shares, of which 8,042,142 were sold by NASDAQ, 4,548,028 shares were sold by NASD, and the remainder sold by certain other stockholders. As a result of these transactions, NASD's ownership in NASDAQ common stock decreased to 11.4 percent.

On May 2, 2006, NASDAQ completed a public offering of 18,500,000 shares of its common stock, generating net proceeds of $664.5 million after deducting offering expenses. NASDAQ also granted the underwriters an option to purchase up to an additional 2,775,000 shares of its common stock to cover over allotments, if any, which the underwriters may exercise within 30 days of the date of the final prospectus. The net proceeds from the above offering were used to repay a portion of the amount outstanding under the $1.1 billion secured term loan of NASDAQ's April 2006 Credit Facility and for general corporate purposes, including possible acquisitions by NASDAQ of further London Stock Exchange plc (LSE) shares or other acquisitions by NASDAQ unassociated with the LSE. See "NASDAQ's Agreement to Acquire Minority Stake in the LSE" and "NASDAQ's April 2006 Credit Facility" below for additional information. Amounts repaid under the secured term loan of NASDAQ's April 2006 Credit Facility will constitute permanent reductions in availability.

Sale of Depository Trust & Clearing Corporation

On March 27, 2006, NASD sold its investment in the Depository Trust & Clearing Corporation for $3.0 million, and recognized a gain of $2.8 million.

Series 7 Exam

As of April 17, 2006, there are 10 class action cases and one individual case pending in federal courts in the District of Columbia, New York, Ohio and Arkansas. NASD has requested the MDL Panel to consolidate these cases in the Southern District of New York. A hearing on NASD's motion will be heard on May 25, 2006. Most of these cases are stayed pending action by the MDL Panel.

NASD 2005 Notes to Consolidated Financial Statements

17. SUBSEQUENT EVENTS (CONTINUED)

NASDAQ's Agreement to Acquire Minority Stake in the LSE

On March 9, 2006, NASDAQ submitted a non-binding indication of interest to acquire all of the shares of the LSE, which was rejected by the LSE on March 10, 2006. On March 30, 2006, NASDAQ announced that it no longer intended to make an offer for the LSE. At that time, NASDAQ reserved the right to announce an offer or possible offer or make and participate in an offer or possible offer for the LSE and/or take any other action which would otherwise be restricted under the rules of the United Kingdom City Code on Takeovers and Mergers, or the City Code, within the next six months with the consent of the United Kingdom Takeover Panel should one of the following events occur:

- an agreement or recommendation from the Board of the LSE;
- an announcement by a third party of an offer for or a merger with the LSE;
- the LSE undertakes or announces an intention to undertake any acquisition or disposal of a material amount, or any material recapitalization other than the LSE's announced return of capital to shareholders of up to GBP 510 million (where "material" is defined as 10.0 percent or more of the LSE's equity market capitalization as at the close of business on March 30, 2006);
- the LSE announces a proposal for shareholder approval that would result in another person acquiring a 30.0 percent or greater shareholding without being required to make an offer for the remaining share capital or reverse takeover; or
- there is a material change in circumstances.

On April 18, 2006, NASDAQ acquired 38,100,000 shares, or 14.9 percent, of the issued share capital of the LSE, at a price of GBP 11.75 per share. The total consideration was GBP 447.7 million, or $784.8 million. In connection with this purchase, NASDAQ entered into a credit facility that provides for credit of up to $1.925 billion of secured financing and NASDAQ currently has approximately $385.1 million available to drawdown under this facility.

On May 8, 2006, NASDAQ acquired an additional 9,790,280 shares, or 3.8 percent, of the issued share capital of the LSE, at a price of GBP 12.18 per share. Total consideration was GBP 119.2 million, or $220.7 million. NASDAQ paid for the shares with cash on hand. Also, on May 10, 2006, NASDAQ announced it acquired an additional 13,791,440 shares of the issued share capital of the LSE, at a price of GBP 12.48 per share. Total consideration for this purchase was GBP 172.1 million, or $320.7 million. In addition to the 47,890,280 shares previously owned, this acquisition takes NASDAQ's holding in the LSE to 61,681,720 shares, or 24.1 percent, of the issued share capital of the LSE. NASDAQ purchased the above shares from LSE shareholders. NASDAQ plans to pay for these shares using $310.1 million of funds available under its April 2006 Credit Facility and $10.6 million from cash on hand.

NASDAQ continues to explore and evaluate its position with respect to the LSE and the purchase of additional LSE shares. NASDAQ may purchase additional LSE shares at any time based on numerous factors, including strategic transactions and potential transactions in its industry, market conditions, LSE share trading prices and the availability of LSE shares for sale. If NASDAQ chooses to purchase additional LSE shares, NASDAQ may incur additional debt.

NASD 2005 Notes to Consolidated Financial Statements

17. SUBSEQUENT EVENTS (CONTINUED)

NASDAQ's April 2006 Credit Facility

NASDAQ entered into the April 2006 Credit Facility, effective on April 18, 2006, to finance its initial purchase of the LSE shares. The April 2006 Credit Facility replaced NASDAQ's former credit agreement obtained in connection with the financing of the INET acquisition and provides for credit of up to $1.925 billion of secured financing. The $1.925 billion available under the April 2006 Credit Facility includes (1) a five-year $75.0 million revolving credit facility, with a letter of credit sub-facility and swingline loan sub-facility; (2) a six-year $750.0 million senior term loan facility; and (3) a six-year $1.1 billion secured term loan facility structured as a delayed-draw term loan (which is limited in use to purchasing LSE shares). The interest rate on loans made under the April 2006 Credit Facility is expected to be either (1) a rate per annum equal to the greater of (a) the rate announced from time to time by Bank of America, N.A. as its "prime rate" and (b) the federal funds effective rate plus 1/2 of 1.0 percent or (2) at the "LIBO Rate" set by the British Banker's Association at 11:00 a.m. two days prior, in each case, plus an applicable margin that varies depending upon the ratings of the loans under the April 2006 Credit Facility most recently received by Moody's Investors Service, Inc. and Standard & Poor's Ratings Group, Inc. NASDAQ has also agreed to pay customary fees and expenses related to the April 2006 Credit Facility and to provide customary indemnities.

NASDAQ's obligations under the April 2006 Credit Facility are secured by a security interest in and liens upon substantially all of its assets and its subsidiaries. All of NASDAQ's domestic subsidiaries are guarantors of its obligations under the April 2006 Credit Facility, excluding the regulated broker-dealer subsidiaries, the insurance-related subsidiaries and The Trade Reporting Facility LLC, or TRF, a joint venture with NASD, which was formed in April 2006.

The April 2006 Credit Facility contains customary negative covenants which will affect NASDAQ's and its consolidated subsidiaries, including the following:

- limitations on the payment of dividends and redemptions of capital stock;
- limitations on loans, guarantees, investments, incurrence of debt and hedging arrangements;
- limitations on issuance and amendment of preferred stock and amendment of subordinated debt agreements;
- prohibition of prepayments, redemptions and repurchases of debt other than debt under the credit facility;
- limitations on liens and sale-leaseback transactions;
- limitations on mergers, recapitalizations, acquisitions and asset sales;
- limitations on transactions with affiliates;
- limitations on restrictions on liens and other restrictive agreements; and
- limitations on changes in its business.

17. SUBSEQUENT EVENTS (CONTINUED)

In addition, the April 2006 Credit Facility contains financial covenants, specifically, maintenance of minimum interest expense coverage ratio and maximum leverage ratio, as defined in the April 2006 Credit Facility and pursuant to the following schedules:

Interest Expense Coverage Ratio

Period	Ratio
Effective Date to June 30, 2006	1.50 to 1.00
July 1, 2006 to September 30, 2006	1.50 to 1.00
October 1, 2006 to March 31, 2007	1.75 to 1.00
April 1, 2007 to September 30, 2007	2.00 to 1.00
October 1, 2007 to March 31, 2008	2.50 to 1.00
April 1, 2008 to September 30, 2008	2.75 to 1.00
October 1, 2008 to March 31, 2009	3.00 to 1.00
April 1, 2009 to September 30, 2009	3.50 to 1.00
Thereafter	4.00 to 1.00

Under the terms of the April 2006 Credit Facility, the Interest Coverage Ratio for the period from April 1, 2006 to June 30, 2006 may be less than 1.50 to 1.00 under certain circumstances, but will not be less than 1.35 to 1.00.

Leverage Ratio

Period	Ratio
Effective Date to June 30, 2006	5.75 to 1.00
July 1, 2006 to September 30, 2006	5.50 to 1.00
October 1, 2006 to December 31, 2006	5.00 to 1.00
January 1, 2007 to March 31, 2007	4.25 to 1.00
April 1, 2007 to June 30, 2007	4.00 to 1.00
July 1, 2007 to September 30, 2007	3.75 to 1.00
October 1, 2007 to December 31, 2007	3.50 to 1.00
January 1, 2008 to March 31, 2008	3.25 to 1.00
April 1, 2008 to December 31, 2008	3.00 to 1.00
January 1, 2009 to September 30, 2009	2.75 to 1.00
Thereafter	2.50 to 1.00

The $1.1 billion secured term loan facility is excluded from the calculation of the Leverage Ratio until October 2007. The April 2006 Credit Facility also contains customary affirmative covenants, including access to financial statements, notice of trigger events and defaults, and maintenance of business and insurance, and events of default, as well as cross-defaults on material indebtedness.

NASD 2005 Notes to Consolidated Financial Statements

17. SUBSEQUENT EVENTS (CONTINUED)

NASDAQ is permitted to repay borrowings under the credit facility at any time in whole or in part, subject to NASDAQ remaining in compliance with the covenants discussed above and its obligation to pay additional fees in certain circumstances. Beginning in 2007, NASDAQ also is required to use a percentage of its excess cash flow to repay loans outstanding under the April 2006 Credit Facility. The percentage of cash flow NASDAQ is required to use for repayments varies depending on its leverage ratio at the end of the year for which cash flow is calculated, with the maximum repayment percentage set at 50.0 percent of excess cash flow.

Sale of Building

As part of NASDAQ's real estate consolidation plans, in April 2006, NASDAQ decided to sell the building it currently owns and occupies in Trumbull, Connecticut. An estimated loss on the sale of the building of approximately $5.0 million will be recorded in the second quarter of 2006.

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Vice President,
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Vice President and
Associate General Counsel

Richard G. Wallace
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Market Regulation

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This Annual Financial Report does not incorporate by reference any other document or information.

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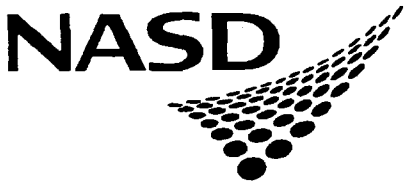
EXHIBIT 2



December 14, 2006

Dear NASD Members:

The NASD Board of Governors has approved the NASD By-Law changes to facilitate the plan to consolidate NASD and NYSE member firm regulation. We developed this plan because we strongly believe it will benefit all NASD members, enhance the integrity and competitiveness of the U.S. financial markets and better protect the investing public. This is a unique opportunity for the industry to shape its future and ensure that self-regulation will have meaningful industry participation.

As you know, the NASD Board of Governors comprises individuals from inside and outside the securities industry. Our public governors come from academia, government and business, while our industry governors represent small, medium and large securities firms—as well as a mix of business models. Both the NASD Board and the senior management team of NASD support this plan and are convinced that its implementation will achieve several important goals, including:

- Reducing compliance costs and fees for all NASD members;
- Streamlining regulation;
- Delivering an immediate economic benefit to every NASD member firm, and creating additional opportunities for future cost savings;
- Ensuring fair and balanced industry representation so that firms of all sizes will have input on future board decisions;
- Making sure U.S. markets keep pace and remain competitive with markets around the world, so that we can continue to attract the capital necessary for economic growth; and
- Ensuring that the regulatory structure we have in place is good for investors.

We are convinced this plan will not only make self-regulation more effective and efficient, but it will ensure that the industry continues to have a meaningful role in making the decisions that will help shape its future. It guarantees robust industry input in the SRO process at a time when other SROs and regulatory bodies have restricted the participation of industry in their governance. We also believe that, by creating a more sensible system of self-regulation, where member firm regulation is conducted by one, truly independent organization operating under a single set of rules, we can better protect U.S. investors and thereby benefit the entire industry.

We strongly believe this is the right way forward for all firms, and ask that you vote **"FOR"** the amendments to the NASD By-Laws.

Sincerely,

Mary L. Schapiro
Chairman and CEO
NASD

Richard F. Brueckner
Presiding Governor
NASD Board of Governors

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
NOTICE OF SPECIAL MEETING OF MEMBERS
TO BE HELD ON JANUARY 19, 2007

To NASD Members:

A special meeting of members of NASD eligible to vote will be held at the NASD Visitors Center at 1735 K Street NW, Washington, D.C. 20006 on January 19, 2007, at 10:00 a.m., Eastern Time, for the following purposes:

- To consider and vote upon a proposal to approve amendments to the NASD By-Laws (the "By-Laws") to implement governance and related changes to accommodate the consolidation of the member firm regulatory functions of NYSE Regulation, Inc. ("NYSE Regulation") and NASD. If approved, the amendments will become effective on the closing of the Transaction (as defined in this proxy statement).

- To transact any other business that may properly come before the special meeting or any adjournment or postponement of the meeting.

The amendments to the By-Laws pertain to certain governance and related changes, which will facilitate the consolidation of the member firm regulatory functions of NASD and NYSE Regulation. NYSE Group, Inc. ("NYSE Group"), the parent of NYSE Regulation, has indicated that it will not proceed with the Transaction if the amendments to the By-Laws are not approved. If the amendments to the By-Laws are approved, corresponding changes will be made to NASD's Certificate of Incorporation.

You may vote in person or by proxy. To grant a proxy to vote, you can use one of the following three methods: (1) call toll free 1-877-381-4017; (2) log onto the website at http://proxy.georgeson.com; or (3) mark, sign and date your proxy card (in the form accompanying this proxy statement) and return it promptly in the postage pre-paid enclosed envelope. You must mail or deliver the proxy card so that it will be received on or before midnight, Eastern Time, on January 18, 2007. If you grant a proxy by phone or internet, do not mail the proxy card.

The record date is December 8, 2006. Subject to applicable law, all NASD members of record at the close of business on the record date, December 8, 2006, are entitled to notice of, and to one vote at, the special meeting. The presence, in person or by proxy, of one-third of the NASD members of record as of the record date is required to constitute a quorum for the transaction of business.

If a quorum is present such that the special meeting may proceed, the amendments to the By-Laws must be approved by a majority of those present, in person or by proxy, and entitled to vote on the matter. If you fail either to send in your proxy or grant a proxy electronically, it will not have any effect on such a vote if a quorum has otherwise been established. While the NASD Board of Governors has the authority to approve the combination of certain assets of NYSE Regulation with NASD and we are not asking for a vote of the members on that Transaction, we cannot complete the Transaction unless the proposed amendments to the By-Laws are approved.

By order of the Board of Governors,

Barbara Z. Sweeney
Senior Vice President and Corporate Secretary

December 14, 2006

FACT SHEET

Transaction

On November 28, NASD and NYSE Group announced a plan to consolidate their member regulation operations into a combined organization that will be the sole U.S. private-sector provider of member firm regulation for securities firms doing business with the public. The combined organization will be responsible for all member firm regulation, arbitration and mediation, and all other current NASD responsibilities, including market regulation by contract for NASDAQ, the American Stock Exchange, and the International Securities Exchange. In addition, the combined organization will be responsible for the professional training, testing and licensing of registered persons, and industry utilities, such as Trade Reporting Facilities and other over-the-counter operations. At the closing of the Transaction, NASD will adopt a new corporate name. We refer to the newly named entity in this proxy statement as the "New SRO".

Strategic Rationale and Consolidation Goals

The consolidation plan, which was approved by the NASD Board of Governors and the Boards of Directors of NYSE Regulation and NYSE Group, will make private-sector regulation more efficient and effective and is designed to accomplish the following goals: It will establish a single self-regulatory organization to serve as the sole U.S. private-sector provider of member firm regulation for securities firms doing business with the public. Going forward, securities firms will operate under a uniform set of rules, replacing the overlapping jurisdiction and duplicative regulation that currently exists. This consolidation will also result in all firms dealing with only one set of examiners and one enforcement staff for member firm regulation. In turn, this will greatly reduce unnecessary regulatory costs while increasing regulatory effectiveness for all firms. One rulebook will give the New SRO the flexibility necessary to more successfully accommodate firms' different business models and sizes in the regulatory structure.

The newly consolidated organization will be committed to reducing regulatory costs and burdens for firms of all sizes through greater regulatory efficiency. The Transaction is designed to offer member firms the following benefits:

- In connection with the Transaction, a one-time special member payment will be made to members in the amount of $35,000 per member;
- The Gross Income Assessment to members — a firm's annual dues to NASD — will be reduced by $1,200 per year for five years, subject to annual Board approval;
- It is expected that we will benefit from economies of scale and will be able to reduce regulatory fees starting in the third year after the closing of the Transaction; and
- The new governance structure guarantees industry participation that ensures fair and balanced member representation on the Board.

Consideration

- NYSE Regulation will transfer to the New SRO approximately 470 employees from functions related to member firm regulation and enforcement and will also transfer related expenses and revenues.

- NASD will pay NYSE Group $103.0 million.
- NASD will also pay the net book value as of closing of the member firm regulatory assets of NYSE Regulation. As of June 30, 2006, the net book value was approximately $15.5 million.
- The Transaction is designed to maintain a neutral financial impact on NYSE Group and NASD.

Governance Structure

A 23-person Board of Governors will oversee the combined organization:

- Ten governors will be from inside the securities industry:
  - Small firms (1-150 registered representatives) elect three seats;
  - Mid-sized firms (151-499 registered representatives) elect one seat;
  - Large firms (500+ registered representatives) elect three seats;
  - Three appointed industry seats: one each for NYSE floor members, independent dealers/insurance affiliates and investment company affiliates.
- Eleven governors will be appointed from outside the securities industry.
- The Chief Executive Officer will serve on the Board of Governors.
- The Chief Executive Officer of NYSE Regulation, Inc. will serve on the Board of Governors for a three-year transitional period, after which such seat automatically will be terminated and the authorized number of members on the Board will be reduced by one.

Member Vote

NASD's By-Laws must be amended to implement the new governance structure. As described in this proxy statement, NASD members are being asked to consider and to vote on the By-Law amendments. The NASD Board recommends that NASD members vote **"FOR"** approval of the amendments to the By-Laws.

SUMMARY

Changes to the NASD By-Laws (see page 25)

We are seeking your approval of the amendments to the NASD By-Laws. These amendments will provide us with a corporate governance structure that will enable us to combine certain assets of NYSE Regulation with our business. If approved, the amendments will become effective on the closing of the Transaction. Appendix A to this proxy statement sets forth the proposed amendments to the By-Laws. Furthermore, as part of the proposed changes to the By-Laws, each of the references to "the NASD" or "NASD" in the By-Laws, even in sections of the By-Laws not included in Appendix A, will be replaced with "the Corporation" in contemplation of a change in the name of the corporation that will occur at the closing of the Transaction. In addition to the foregoing, as part of the proposed changes to the By-Laws, each of the references to the "Rules of the Association" in the By-Laws, even in sections of the By-Laws not included in Appendix A, will be replaced with the "Rules of the Corporation". If the amendments to the By-Laws are approved, corresponding changes will be made to NASD's Certificate of Incorporation.

Recommendation of the NASD Board (see page 16)

The NASD Board recommends that NASD members vote "**FOR**" approval of the amendments to the By-Laws.

The Transaction Terms (see page 16)

NASD and NYSE Group have negotiated a non-binding Term Sheet (the "Term Sheet") that includes the following principal terms relating to the Transaction:

- NYSE Regulation will transfer to the New SRO approximately 470 employees from functions related to member firm regulation and enforcement and will also transfer related expenses and revenues.
- NYSE Group will retain all existing employee liabilities and related assets as of the date of the closing of the Transaction, except the New SRO will assume the responsibility to pay the regulatory cash awards of approximately $8.0 million to be paid to NYSE Regulation transferred employees in 2008 and 2009.
- NASD will pay NYSE Group $103.0 million.
- NASD also will pay the net book value as of closing of the member firm regulatory assets of NYSE Regulation. As of June 30, 2006, the net book value was approximately $15.5 million.
- The Transaction is designed to maintain a neutral financial impact on NYSE Group and NASD.
- NYSE Group will support and maintain, consistent with its past practice, its existing technology systems that support member firm regulation for a fixed transition period of one year from the closing of the Transaction while such systems are migrated to the New SRO. NYSE Group and NASD expect to work in good faith to transfer owned and licensed intellectual property and related assets and migrate all usable and transferable portions of the technology systems transferred within the one year transition period.
- Any services provided by NYSE Group to the New SRO or by the New SRO to NYSE Group during the one year period following the closing of the Transaction shall be based on direct expense hours and actual rates incurred plus a 25% mark-up.

- The New SRO will sublease or license from NYSE Group approximately 76,000 square feet located at 14 Wall Street and 90,800 square feet at 20 Broad Street in New York City. The sublease or license will be based on pre-existing cost allocations without markup.
- At the closing of the Transaction, NASD will adopt a new corporate name.
- NYSE Group and the New SRO will enter into a five-year services agreement not to exceed $10 million per year for the lease of the space and to pay for the related security services and other reasonable direct and allocated occupancy and security costs.
- The governance and related changes reflected in the proposed amendments to the NASD By-Laws.

Special Member Payment and Effect of the Transaction on the Members (see page 22)

The consolidation will reduce the costs of regulation. In connection with the Transaction, a one-time special member payment will be made to NASD members. The special member payment will be $35,000 per NASD member. In addition, we will discount the annual gross income assessment to members for a period of five years, subject to annual Board approval. Each firm would receive a discount of $1,200 per year, which is the minimum annual gross income assessment charge and the total amount of the annual gross income assessment that approximately 2,400 member firms pay. As a result of this discount, the approximately 2,400 member firms currently paying the minimum would pay no gross income assessments charge over the five-year period. It is expected that we will benefit from economies of scale and will be able to reduce regulatory fees starting in the third year after the closing of the Transaction.

Firms that today are regulated by both NASD and NYSE Regulation will benefit from the elimination of the current duplication of regulatory review of these firms. The Transaction will further benefit all NASD members as it will streamline the broker-dealer regulatory system, combine technologies, and establish a single set of rules and group examiners with complementary areas of expertise in a single organization – all of which will serve to enhance oversight of U.S. securities firms and help ensure investor protection. Moreover, we are committed to reducing regulatory costs and burdens for firms of all sizes through greater regulatory efficiency.

As a result of the By-Law amendments, members will no longer have the ability to vote for all Board candidates in elections, but will have an opportunity to vote on designated seats on the Board. Specifically, firms will vote for industry nominees that are similar in size to their own firm. This means that small firms and large firms will vote for candidates running for the seats reserved for their firm size and the mid-sized firms will likewise vote for the mid-sized firm seat. All other Board seats will be appointed. All members will continue to have the ability to vote on any future By-Law amendments, as well as in district elections. In addition, the New SRO will continue NASD's current practice of subject-matter expert standing committees and NASD's current notice and comment process for rule-making.

To further encourage small firm input and participation, NASD has enhanced the existing Small Firm Advisory Board by making half of the seats elected. The Small Firm Advisory Board will continue to review New SRO rules and make recommendations to the Board of Governors.

The Special Meeting of Members (see page 23)

A special meeting of members of NASD eligible to vote will be held at the NASD Visitors Center at 1735 K Street, NW, Washington, D.C. 20006 on January 19, 2007, at 10:00 a.m., Eastern Time, to consider and vote upon a proposal to approve amendments to the NASD By-Laws to implement governance and related changes to accommodate the Transaction.

Composition of Board of Governors after the Closing of Transaction (see page 17)

During the Transitional Period

Following the closing of the Transaction, the New SRO will have a Board of 23 governors as follows: (1) eleven of the governors will be "Public Governors", (2) ten of the governors will be "Industry Governors" and (3) two of the governors will be Richard G. Ketchum, Chief Executive Officer of NYSE Regulation, and Mary L. Schapiro, Chief Executive Officer of the New SRO.

The eleven Public Governors will have no material business relationship with a broker or dealer or a self-regulatory organization registered under the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Of the ten Industry Governors:

- Three will be registered with and elected by small member firms that employ at least 1 and no more than 150 registered persons;
- One will be registered with and elected by mid-size member firms that employ at least 151 and no more than 499 registered persons;
- Three will be registered with and elected by large member firms that employ 500 or more registered persons;
- One will be associated with a floor member of the New York Stock Exchange;
- One will be associated with an independent dealer or insurance affiliate; and
- One will be associated with an investment company or investment company affiliate.

After the Transitional Period

Following the Transitional Period, the industry seats on the Board will remain the same. In addition, the seat for the Chief Executive Officer of NYSE Regulation automatically will be terminated, and the authorized number of members on the Board will be reduced by one.

Conditions to Completion of the Transaction (see page 21)

Completion of the Transaction is subject to the satisfaction or waiver of a number of conditions, including the execution of definitive agreements between the parties, as well as the approval of the amendments to the By-Laws by the requisite affirmative vote of the NASD members at the special meeting.

Regulatory Filings and Approvals to Complete the Transaction (see page 21)

We expect to file with the Antitrust Division of the U.S. Department of Justice and the Federal Trade Commission in accordance with the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "HSR Act"). In addition, the amendments to the By-Laws must be approved by the Securities and Exchange Commission (the "SEC"). Finally, the Transaction is conditioned upon a favorable ruling by the Internal Revenue Service (the "IRS") that the Transaction will not affect the tax-exempt status of NASD or NASD Regulation, Inc. ("NASDR").

QUESTIONS AND ANSWERS

The following questions and answers highlight selected information from this proxy statement and may not contain all of the information that is important to you. For additional information concerning the amendments to the NASD By-Laws and the Transaction, you should read this proxy statement in its entirety, as well as the amendments to the NASD By-Laws attached as Appendix A hereto. The following questions and answers are qualified in their entirety by the amendments to the NASD By-Laws.

Questions and Answers Regarding the Transaction

Q: What is the Transaction?

A: NASD and NYSE Group have entered into the Term Sheet evidencing the intention of NYSE Group and NASD to consolidate NASD and the member firm regulatory functions of NYSE Regulation. The consolidation would be effected through the transfer to the New SRO of certain NYSE Regulation assets related to member firm regulation. We refer to the consolidation and transfer in this proxy statement as the "Transaction".

The financial terms of the Transaction include the following:

- NYSE Regulation will transfer to the New SRO approximately 470 employees from functions related to member firm regulation and enforcement and will also transfer related expenses and revenues.
- NYSE Group will retain all existing employee liabilities and related assets as of the date of the closing of the Transaction, except the New SRO will assume the responsibility to pay the regulatory cash awards of approximately $8.0 million to be paid to NYSE Regulation transferred employees in 2008 and 2009.
- NASD will pay NYSE Group $103.0 million.
- NASD also will pay the net book value as of closing of the member firm regulatory assets of NYSE Regulation. As of June 30, 2006, the net book value was approximately $15.5 million.
- The Transaction is designed to maintain a neutral financial impact on NYSE Group and NASD.

At the closing of the Transaction, NASD will adopt a new corporate name.

A 23-member Board of Governors will oversee the New SRO during the Transitional Period. Mary L. Schapiro, the current Chairman and Chief Executive Officer of NASD, will serve as the New SRO's Chief Executive Officer. Richard G. Ketchum, Chief Executive Officer of NYSE Regulation and a former NASD senior executive, will serve as Non-Executive Chairman of the New SRO during the Transitional Period. Following the Transitional Period, the industry seats on the Board will remain the same. In addition, following the Transitional Period, the seat for the Chief Executive Officer of NYSE Regulation automatically will be terminated and the authorized number of members of the Board will be reduced by one.

Q: What is the purpose of the Transaction?

A: The principal goals of the Transaction are to establish a single self-regulatory organization to serve as the sole U.S. private-sector provider of member firm regulation for securities firms doing business with the public, and to build and sustain the confidence critical to the operation of vibrant capital markets. Moreover, the purpose of the Transaction is to increase efficient, effective and consistent regulation of securities firms to provide cost savings to securities firms, while also strengthening investor protection and market integrity.

Q: What are the benefits of the Transaction to NASD members?

A: In connection with the Transaction, a one-time special payment will be made to NASD members (the "special member payment"). This special member payment will be $35,000 per NASD member, or approximately $175.0 million in the aggregate. The special member payment will be made to NASD members of record as of the close of business on the business day next immediately preceding the day of closing of the Transaction and will be payable as of the close of business on the date of the closing of the Transaction. In addition, we will discount the annual gross income assessment to members for a period of five years, subject to annual Board approval. Each firm would receive a discount of $1,200 per year, which is the minimum annual gross income assessment charge and the total amount of the annual gross income assessment that approximately 2,400 member firms pay. As a result of this discount, the approximately 2,400 member firms currently paying the minimum would pay no gross income assessments charge over the five-year period. For U.S. federal income tax purposes, the special member payment will be includible in a member's taxable income as ordinary income. A discount in the annual gross income assessment will have no consequence for U.S. federal income tax purposes unless it is effected by means of a rebate of amounts previously deducted, in which case the rebate will be includible in a member's taxable income as ordinary income.

The Transaction will further benefit NASD members as it will streamline the broker-dealer regulatory system, combine technologies, and permit the establishment of a single set of rules and group examiners with complementary areas of expertise in a single organization—all of which will serve to enhance oversight of U.S. securities firms and help ensure investor protection. Moreover, we are committed to reducing regulatory costs and burdens for firms of all sizes through greater regulatory efficiency. It is expected that we will gain benefits from economies of scale and will be able to reduce regulatory fees starting in the third year after closing of the Transaction.

Q: Can NASD increase the amount of the $35,000 one-time special member payment?

A: A larger payment is not possible. NASD is a tax-exempt organization and therefore is limited by tax laws regarding size and source of payments it can make to its members. The special member payment of $35,000 per NASD member, or approximately $175.0 million in the aggregate, will be funded by—and therefore limited by—the expected value of the incremental cash flows that will be produced by the consolidation transaction. If the special member payment was higher, it could seriously jeopardize NASD's status as a tax-exempt organization, which would result in significantly higher fees for firms.

Q. Are the terms of the Transaction fixed?

A. While some approval processes remain, including the NASD member vote and SEC approval of the By-Law amendments, and the Transaction is subject to the execution of definitive documentation, the terms of the Transaction were heavily negotiated with the NYSE Group and we do not expect any material change in the terms. NYSE Group has indicated that it will not proceed with the Transaction if the amendments to the By-Laws are not approved.

Q. What are the risks if the By-Law amendments are not approved?

A. It is not possible to know with certainty. The Transaction is the product of months of negotiation between the NYSE Group and NASD, and NYSE Group has indicated that it will not proceed with the Transaction if the amendments to the By-Laws are not approved. Furthermore, the concept of a hybrid regulator has the strong support of the SEC. There is every reason to believe that if the By-Law amendments are not approved by the NASD membership, and the Transaction does not close, the SEC will make its own decision about the structure and governance of SROs.

The SEC has embraced an NYSE-model of SRO governance that has no industry representation on its Board and has mandated a majority of non-industry representation on the NASD Board. Therefore, we believe the Transaction is the best way to ensure significant and broad-based industry representation on the Board of Governors now and in the future.

Q: What effect will the vote of the members have on the Transaction?

A: The Board of Governors has the authority to approve the Transaction and members are being asked only to approve the amendments to the NASD By-Laws. However, one of the conditions to the closing of the Transaction is member approval of the amendments to the By-Laws. If the amendments to the By-Laws are approved, corresponding changes will be made to NASD's Certificate of Incorporation.

Q: Why is it being proposed that all firms no longer vote on all Board candidates in elections?

A: The proposed governance structure is a result of extensive negotiations between NASD and NYSE Group, including extensive input from the current NASD Board of Governors which is populated by a diverse group of industry and public members. As with any negotiation, certain compromises are reached. A bedrock principle of NASD during the negotiation was to continue with broad, diverse industry representation on the Board of Governors. The current NYSE Board of Directors has no industry representation. The new board structure, including voting rights for board members, reflects a blend of current NASD and NYSE Group structures. A deal would not have been reached with NYSE Group if each member of the new SRO had the right to vote on all Board candidates in elections.

Q: What voting rights will members have with respect to the election of Board members if the amendments to the By-Laws are approved?

A: As a result of the By-Law amendments, members will no longer have the ability to vote for all Board candidates in elections, but will have an opportunity to vote on designated seats on the Board. Specifically, firms will vote for industry nominees that are similar in size to their own firm. This means that small firms and large firms will vote for candidates running for the seats reserved for their firm size and the mid-sized firms will likewise vote for the mid-sized firm seat. All other Board seats will be appointed. During the Transitional Period, the appointed Board seats will consist of the following:

- Eleven governors who will be appointed from outside the industry. The current NASD and NYSE Group Boards each will appoint five Public Governors, and one Public Governor will be appointed jointly by the current NASD and NYSE Group Boards.

- Three Industry Governors, consisting of a representative of a New York Stock Exchange floor member (appointed by the NYSE Group Board), a representative of independent dealers/ insurance affiliates (appointed by the current NASD Board) and a representative of investment company affiliates (appointed jointly by the current NASD and NYSE Group Boards).

Following the Transitional Period, the New SRO Board will appoint persons to fill the three appointed industry seats and the public seats.

All members will continue to have the ability to vote on any future By-Law amendments, as well as in district elections. In addition, the New SRO will continue NASD's current practice of subject-matter expert standing committees and NASD's current notice and comment process for rule-making.

Q: What will be the composition of the Board after closing?

A: As of the date of this proxy statement, the NASD Board of Governors consists of the following individuals: Mary L. Schapiro, William C. Alsover, John W. Bachmann, Charles A. Bowsher, John J. Brennan, Richard F. Brueckner, James E. Burton, Sir Brian Corby, Admiral Tyler F. Dedman, U.S. Navy (Retired), William H. Heyman, Brian J. Kovack, Judith R. MacDonald, John Rutherfurd, Jr., Joel Seligman, John S. Simmers and Sharon P. Smith.

After the closing of the Transaction, operations of the New SRO will be overseen during the Transitional Period by a Board of Governors comprised of 23 members. They include:

- Richard G. Ketchum, Non-Executive Chairman.
- Mary L. Schapiro, Chief Executive Officer.
- Eleven governors who will be appointed from outside the industry. The current NASD and NYSE Group Boards each will appoint five Public Governors; and one Public Governor will be appointed jointly by the current NASD and NYSE Group Boards.
- Ten governors who will be from within the industry. Seven of those governors will be elected, and the remaining three appointed. The new structure preserves member participation and guarantees that firms of all sizes will have representation on the Board:
    - Small firms (1–150 registered persons) will have three representatives. Small firms will vote on a slate of candidates nominated by the NASD Board and they may also present their own slates of nominees.
    - Mid-sized firms (151–499 registered persons) will have one representative. Mid-sized firms will elect their representative from a candidate nominated by the current NYSE Group and NASD Boards and they may also present their own nominees.
    - Large firms (500 or more registered persons) will have three representatives. Large firms will vote on a slate of candidates nominated by the NYSE Group Board and they may also present their own slates of nominees.
    - The remaining three seats will be filled by a representative of a New York Stock Exchange floor member (appointed by the NYSE Group Board), a representative of independent dealers/insurance affiliates (appointed by the current NASD Board) and a representative of investment company affiliates (appointed jointly by the current NASD and NYSE Group Boards).

To allow for the possibility of a contested election, nominees for the three small firm governor seats, one mid-sized firm seat and three large firm seats will be voted upon at an annual meeting of members expected to be held within ninety days after the closing of the Transaction. Prior to closing of the Transaction, the Board of Governors of NASD and the Board of NYSE Group will nominate persons to stand for election for these seven seats at the annual meeting. During the interim period from closing of the Transaction until the annual meeting, these seven seats will be filled by three governors appointed by the NASD Board prior to the closing of the Transaction from industry governors currently on the NASD Board, three governors appointed by the Board of NYSE Group and one governor jointly appointed by the Board of NYSE Group and the NASD Board prior to the closing of the Transaction (these seven appointed governors are referred to in this proxy statement as the "Interim Industry Governors").

Following the Transitional Period, the industry seats on the Board will remain the same. In addition, the seat for the Chief Executive Officer of NYSE Regulation will automatically be

terminated and the authorized number of members of the Board will be reduced by one. The proposed By-Laws provide that, after the Transitional Period, NYSE Group will have no right to appoint or nominate any governors to the New SRO Board.

Q: What will be the role and composition of the Nominating Committee?

A: The Nominating Committee will be a committee of the New SRO Board and will replace the current National Nominating Committee. For the first annual meeting following the closing of the Transaction, nominations for the seven elected industry seats will be not be made by the Nominating Committee, but instead by the Board of Governors of NASD and the NYSE Group Board prior to the closing of the Transaction. In addition, prior to the closing the Board of Governors of NASD and the NYSE Group Board will identify and appoint persons for the eleven public seats and three remaining industry seats. During the Transitional Period, the Nominating Committee will be responsible solely for nominating persons to fill vacancies in governor seats for which the full Board has the authority to fill. Following the Transitional Period, the Nominating Committee will be responsible for nominating persons for appointment or election to the Board, as well as nominating persons to fill vacancies in appointed or elected governor seats.

During the Transitional Period, members of the Nominating Committee will be appointed jointly by the New SRO Chief Executive Officer and the Chief Executive Officer of NYSE Regulation as of closing of the transaction (or his duly appointed successor as chair of the Board), subject to ratification of the appointees by the New SRO Board. Following the Transitional Period, the composition of the Nominating Committee will be determined by the New SRO Board. At all times, the number of Public Governors on the Nominating Committee must equal or exceed the number of Industry Governors on the Nominating Committee. In addition, the Nominating Committee must at all times be comprised of a number of governors that is a minority of the entire Board. The New SRO Chief Executive Officer may not be a member of the Nominating Committee.

Q: Who will be the leadership of the New SRO following the closing of the Transaction?

A: The Chief Executive Officer will be Mary L. Schapiro and the Non-Executive Chairman will be Richard G. Ketchum.

Q: How was the value of NYSE Regulation's member firm regulation functions determined?

The financial terms of the Transaction include the following:

- NYSE Regulation will transfer to the New SRO approximately 470 employees from functions related to member firm regulation and enforcement and will also transfer related expenses and revenues.
- NYSE Group will retain all existing employee liabilities and related assets as of the date of the closing of the Transaction, except the New SRO will assume the responsibility to pay the regulatory cash awards of approximately $8.0 million to be paid to NYSE Regulation transferred employees in 2008 and 2009.
- NASD will pay NYSE Group $103.0 million.
- NASD also will pay the net book value as of closing of the member firm regulatory assets of NYSE Regulation. As of June 30, 2006, the net book value was approximately $15.5 million.
- The Transaction is designed to maintain a neutral financial impact on NYSE Group and NASD.

The amounts of these payments were determined through arm's-length negotiations between NASD and NYSE Group, and NASD believes they reflect fair value for the transferred functions.

NASD has engaged an independent third-party financial advisor to determine whether the consideration to be paid by NASD in the Transaction is fair to NASD from a financial point of view. Subject to SEC filing requirements, NYSE Group expects to reduce its gross FOCUS (Financial and Operational Combined Uniform Single Report) fee by 75% following the closing of the Transaction and, subject to SEC filing requirements, a similar amount is expected to be charged by the New SRO.

Q: What is being transferred by NYSE Regulation?

A: Employees and related expenses and revenues from the following NYSE Regulation functions are being transferred to the New SRO: member firm regulation, enforcement (not including market surveillance and trading rules enforcement), risk assessment (the portion thereof that is concerned with member firm regulation issues) and arbitration.

Q: When do the NASD and NYSE Group expect to close the Transaction?

A: NASD and NYSE Group expect to close the Transaction on or before April 2, 2007.

Questions and Answers Regarding the Special Meeting

Q: Why am I receiving this proxy statement?

A: A special meeting of NASD members will take place on January 19, 2007 to consider and vote upon the amendments to the NASD By-Laws.

This proxy statement describes the Transaction and the matters to be voted on at the special meeting. You should read the entire document carefully.

Q: What are NASD members being asked to approve at the special meeting?

A: NASD members are only being asked to approve the amendments to the By-Laws and are not being asked to approve the Transaction.

Q: Why is NASD proposing these amendments to the By-Laws?

A: NASD is proposing these amendments to the By-Laws in order to implement the corporate governance structure contemplated by the Transaction.

Q: What is the recommendation of the NASD Board?

A: The NASD Board recommends that NASD members vote **"FOR"** approval of the amendments to the By-Laws.

Q: In order for the amendments to become effective, how many NASD members must give their approval?

A: The record date is December 8, 2006. Subject to applicable law, all NASD members of record at the close of business on December 8, 2006 are entitled to notice of, and to one vote at, the special meeting. The presence, in person or by proxy, of one-third of the NASD members is required to constitute a quorum for the transaction of business.

If a quorum is present such that the special meeting may proceed, the amendments to the NASD By-Laws must be approved by a majority of those present, in person or by proxy, at the special meeting and entitled to vote on the matter. The NASD Board has set the close of business on December 8, 2006 as the record date for determining NASD members' eligibility to vote on the By-Laws amendments at the special meeting.

Q: How do I vote?

A: You may vote in person or by proxy. To grant a proxy to vote, you can use one of the following three methods: (1) call toll free 1-877-381-4017; (2) log onto the website at http://proxy.georgeson.com; or (3) mark, sign and date your proxy card (in the form accompanying this proxy statement) and return it promptly in the postage pre-paid enclosed envelope. You must mail or deliver the proxy card so that it will be received on or before midnight, Eastern Time, on January 18, 2007. If you grant a proxy by phone or internet, do not mail the proxy card.

A form of proxy card for your use at the special meeting accompanies this proxy statement. All properly executed proxies that are received prior to or at the special meeting and not revoked will be voted at the special meeting in the manner specified. If you execute and return a proxy and do not specify otherwise, your proxy will be voted **"FOR"** approval of the amendments to the By-Laws in accordance with the recommendation of the NASD Board. Please see "Information Concerning the Special Meeting – Voting and Revocation of Proxies" in this proxy statement for more information.

Q: What do I need to do now?

A: You should complete, date and sign your proxy card (in the form accompanying this proxy statement) and mail it in the enclosed return envelope or grant a proxy electronically as soon as possible so that your membership interest may be represented at the special meeting, even if you plan to attend the meeting in person.

Q: May I change my vote after I have mailed my signed proxy card or granted a proxy electronically?

A: If you have signed and mailed a proxy card distributed to you by NASD or granted a proxy electronically in the manner described in this proxy statement, you can change your vote by sending in a dated letter, signed proxy card or a written revocation, or granting a proxy electronically at a later date, before the special meeting or by attending the special meeting and voting in person. Your attendance at the meeting will not, by itself, revoke your proxy. Please see "Information Concerning the Special Meeting" in this proxy statement for more information.

We understand that certain groups or individuals may have asked you to sign a purported irrevocable proxy and power of attorney. These groups and individuals are not acting at the direction, or with the support, of NASD, the NASD Board or NASD management, and such document is not being distributed by or on behalf of NASD, the NASD Board or NASD management. If you sign such a document, it is possible that you may not have the ability to change your vote after you sign it. Accordingly, in order to preserve your ability to change your vote, we urge you to grant a proxy only using a proxy card distributed by NASD or electronically in the manner described in this proxy statement.

Q: What happens if I do not send in my proxy or grant a proxy electronically?

A: If you fail to either send in your proxy or grant a proxy electronically, it will not have any effect on such a vote if a quorum has otherwise been established.

Q: Who can help answer my questions?

A: If you have additional questions about the special meeting or would like additional copies of this proxy statement, you should contact Georgeson, our proxy solicitors, toll free at 1-866-647-8875.

Q: When will the amendments to the By-Laws become effective?

If the amendments to the By-Laws are approved, they will become effective at the closing of the Transaction.

THE TRANSACTION

Background and Reasons for the Transaction

The securities industry—both domestically and internationally—is in the midst of dramatic change. As the industry changes, it has become clear that the self-regulatory organization ("SRO") model must be adapted to ensure efficient and effective regulation. At the moment, two SROs, NASD and NYSE Regulation, oversee the activities of U.S.-based broker-dealers doing business with the public, approximately 170 of which are regulated by both organizations. The result is a duplicative, sometimes conflicting system that makes inefficient use of resources and, as such, can be detrimental to the ultimate goal of investor protection.

NASD has long supported the idea of one SRO having responsibility for all member firm regulation. At the same time, the SEC, Congress, securities firms and independent observers have long encouraged greater efficiencies, clarity and cost savings in the regulation of America's financial markets. For these reasons, NASD and NYSE Regulation joined together proactively to design a system that will better meet the needs of today's investors and securities firms.

The dialogue between the two organizations was aimed at eliminating, to the extent possible, the conflicts and discrepancies in the NASD and NYSE Regulation rulebooks. The SROs convened a series of industry committees to assist in this effort. Each committee was responsible for reviewing comparable NASD and NYSE Regulation rules and making recommendations, recognizing the possibility that different standards will still be appropriate in some cases, given the organizations' varied membership and certain differences in regulatory approaches.

With the support and encouragement of the SEC, NASD and NYSE Group representatives began meeting in June 2006 to discuss options for changes to the self-regulatory system. A determination was made that the scope of the discussions should be limited to eliminating redundant member regulation and not to combine the market regulatory responsibilities of NASD and NYSE Regulation. Those meetings continued through November 2006, as issues of governance, staffing, and financial impact to NASD and NYSE Group were addressed. Eventually, the two organizations determined to consolidate securities firm regulation operations into one SRO that will be the sole U.S. private-sector provider of member firm regulation for securities firms that do business with the public. This consolidation will streamline the broker-dealer regulatory system, combine technologies, permit the establishment of a single set of rules and group examiners with complementary areas of expertise in a single organization—all of which will serve to enhance oversight of U.S. securities firms and help ensure investor protection. Moreover, the new organization will be committed to reducing regulatory costs and burdens for firms of all sizes through greater regulatory efficiency. The NASD and NYSE Group representatives negotiated the Term Sheet evidencing the intent of the two parties to combine the member firm regulatory functions of NYSE Regulation with NASD and setting forth the principal terms for the consolidation, subject to the approval of their respective Boards. The Term Sheet was presented to and approved by the respective Boards of NASD and NYSE Group on November 21, 2006 and November 20, 2006, respectively. The Term Sheet was signed by NYSE Group and NASD on November 27, 2006 and November 28, 2006, respectively.

The goals of the consolidation plan are to:

- establish a single self-regulatory organization to serve as the sole U.S. private-sector provider of member firm regulation for securities firms that do business with the public;
- build and sustain the confidence critical to the operation of vibrant capital markets;
- increase efficient, effective and consistent regulation of securities firms;

- provide cost savings to securities firms of all sizes; and
- strengthen investor protection and market integrity.

None of NASD's current functions and activities will be eliminated as a result of the Transaction. The combined organization will be responsible for:

- regulatory oversight of all securities firms that do business with the public;
- professional training, testing and licensing of registered persons;
- arbitration and mediation;
- market regulation by contract for NASDAQ, the American Stock Exchange, and the International Securities Exchange; and
- Industry utilities, such as Trade Reporting Facilities and other over-the-counter operations.

The consolidation plan addresses several of the key issues raised in the SEC's 2004 *Concept Release Concerning Self-Regulation*, including: (1) the inherent conflicts of interest between SRO regulatory operations and members, market operations, issuers and stockholders; (2) the costs and inefficiencies of multiple SROs, arising from multiple SRO rulebooks, inspection regimes and staff; and (3) the funding SROs have available for regulatory operations and the manner in which SROs allocate revenue to regulatory operations.

The closing of the Transaction and the consolidation of the member firm regulatory functions of the two organizations is subject to the approval of the proposed amendments to the NASD By-Laws, the execution of definitive agreements between NASD and NYSE Group, and obtaining certain regulatory approvals. The financial terms of the Transaction include the following:

- NYSE Regulation will transfer to the New SRO approximately 470 employees from functions related to member firm regulation and enforcement and will also transfer related expenses and revenues.
- NYSE Group will retain all existing employee liabilities and related assets as of the date of the closing of the Transaction, except the New SRO will assume the responsibility to pay the regulatory cash awards of approximately $8.0 million to be paid to NYSE Regulation transferred employees in 2008 and 2009.
- NASD will pay NYSE Group $103.0 million.
- NASD also will pay the net book value as of closing of the member firm regulatory assets of NYSE Regulation. As of June 30, 2006, the net book value was approximately $15.5 million.
- The Transaction is designed to maintain a neutral financial impact on NYSE Group and NASD.

The amounts of these payments were determined through arm's-length negotiations between NASD and NYSE Group, and NASD believes they reflect fair value for the transferred functions. NASD has engaged an independent third-party financial advisor to determine whether the consideration to be paid by NASD in the Transaction is fair to NASD from a financial point of view.

In connection with the Transaction, a one-time special member payment will be made to NASD members. The special member payment will be $35,000 per NASD member. In addition, we will discount the annual gross income assessment to members for a period of five years, subject to annual Board approval. Moreover, we are committed to reducing regulatory costs and burdens for firms of all sizes through greater regulatory efficiency. It is expected that we will gain benefits from economies of scale and will be able to reduce regulatory fees starting in the third year after closing of the Transaction.

The Transaction will require amendments to the current NASD By-Laws. If a quorum is present at the special meeting of members, such that the special meeting may proceed, the amendments to the By-Laws will require the approval of a majority of the members present, in person or by proxy, at the special meeting and entitled to vote on the matter. If approved, the amendments will become effective upon closing of the Transaction. In addition, if the amendments to the By-Laws are approved, corresponding changes will be made to NASD's Certificate of Incorporation.

The amendments to the By-Laws will implement the governance changes at the combined organization, including a Board structure that balances public and industry representation, and designates certain governor seats to represent member firms of various sizes. A 23-member Board of Governors will oversee the combined organization during the Transitional Period. Mary L. Schapiro, the current Chairman and Chief Executive Officer of NASD, will serve as the New SRO Chief Executive Officer. Richard G. Ketchum, Chief Executive Officer of NYSE Regulation and a former NASD senior executive, will serve as Non-Executive Chairman of the New SRO during the Transitional Period.

The new board structure reflects a blend of current NASD and NYSE Group structures. While not a component of NYSE Group's existing structure, NASD's tradition of industry and member representation will continue in the combined organization. Member firms of all sizes will be represented on the New SRO Board after the closing of the Transaction, with a combined total of ten seats.

Small, mid-sized and large firms will each elect certain governors, as follows:

- Small firms (1-150 registered persons) will have three representatives. Small firms will vote on a slate of candidates nominated by the NASD Board and they may also present their own slates of nominees.

- Mid-sized firms (151-499 registered persons) will have one representative. Mid-size firms will elect their representative from a candidate jointly nominated by the current NYSE Group and NASD Boards and they may also present their own nominees.

- Large firms (500 or more registered persons) will have three representatives. Large firms will vote on a slate of candidates nominated by the NYSE Group Board and they may also present their own slates of nominees.

Three additional Industry Governors will be appointed:

- Three seats will be filled by a representative of a New York Stock Exchange floor member (appointed by the NYSE Group Board), a representative of independent dealers/insurance affiliates (appointed by the current NASD Board), and a representative of investment company affiliates (jointly appointed by the NYSE Group Board and the current NASD Board).

The composition of the other seats includes:

- Eleven governors appointed from outside the industry, of which the current NASD Board and the NYSE Group Board will each appoint five Public Governors and one Public Governor will be appointed jointly by the NYSE Group Board and the current NASD Board.

To further encourage small firm input and participation, NASD has enhanced the existing Small Firm Advisory Board, making half of the seats elected. The Small Firm Advisory Board will continue to review the New SRO rules and make recommendations to the Board of Governors.

Following the Transitional Period, the industry seats on the Board will remain the same. In addition, the seat for the Chief Executive Officer of NYSE Regulation will automatically be terminated and the

authorized number of members of the Board will be reduced by one. The proposed By-Laws provide that, after the Transitional Period, NYSE Group will have no right to appoint or nominate any governors to the New SRO Board.

As a result of the By-Law amendments, members will no longer have the ability to vote for all Board candidates in elections, but will have an opportunity to vote on designated seats on the Board. Specifically, firms will vote for industry nominees that are similar in size to their own firm. This means that small firms and large firms will vote for candidates running for the seats reserved for their firm size and the mid-sized firms will likewise vote for the mid-sized firm seat. All other Board seats will be appointed as described above. All members will continue to have the ability to vote on any future By-Law amendments, as well as in district elections. In addition, the New SRO will continue NASD's current practice of subject-matter expert standing committees and NASD's current notice and comment process for rule-making.

Deliberations of the NASD Board

NASD and NYSE Group representatives began meeting in June 2006 to discuss options for changes to the self-regulatory system. In September 2006, the Board of Governors of NASD met to review the proposed outline of the Transaction. NASD and NYSE Group continued with meetings through November 2006, as issues of governance, staffing, and financial impact on NASD and NYSE Group were addressed. The NASD and NYSE Group representatives negotiated the Term Sheet, subject to approval by their respective Boards. The NASD Board approved the Term Sheet on November 21, 2006. On December 6, 2006 and December 13, 2006, the NASD Board approved the amendments to the By-Laws, with one governor abstaining and one governor voting against at the December 6, 2006 meeting. As part of its approval of the Transaction, the NASD Board is recommending that NASD members vote **"FOR"** the approval of the amendments to the By-Laws.

Terms of the Transaction

Financial

The financial terms of the Transaction include the following:

- NYSE Regulation will transfer to the New SRO approximately 470 employees from functions related to member firm regulation and enforcement and will also transfer related expenses and revenues.
- NYSE Group will retain all existing employee liabilities and related assets as of the date of the closing of the Transaction, except the New SRO will assume the responsibility to pay the regulatory cash awards of approximately $8.0 million to be paid to NYSE Regulation transferred employees in 2008 and 2009.
- NASD will pay NYSE Group $103.0 million.
- NASD also will pay the net book value as of closing of the member firm regulatory assets of NYSE Regulation. As of June 30, 2006, the net book value was approximately $15.5 million.
- The Transaction is designed to maintain a neutral financial impact on NYSE Group and NASD.

The amounts of these payments were determined through arm's-length negotiations between NASD and NYSE Group, and NASD believes they reflect fair value for the transferred functions. NASD has engaged an independent third-party financial advisor to determine whether the consideration to be paid by NASD in the Transaction is fair to NASD from a financial point of view. Subject to SEC filing requirements, NYSE Group expects to reduce its gross FOCUS (Financial and Operational Combined Uniform Single Report) fee by 75% following the closing of the Transaction and, subject to SEC filing requirements, a similar amount is expected to be charged by the New SRO.

Employees

NYSE Group will transfer approximately 470 employees and related expenses and revenues from NYSE Regulation to the New SRO. NYSE Group will retain all existing employee liabilities and related assets as of the closing of the Transaction, except that the New SRO will assume the responsibility to pay the regulatory cash awards of approximately $8.0 million to be paid to NYSE Regulation transferred employees in 2008 and 2009.

The approximately 470 transferred NYSE Regulation employees work in the following areas: member firm regulation, enforcement (not including market surveillance and trading rules enforcement), risk assessment (the portion thereof that is concerned with member firm regulation issues) and arbitration. NYSE Regulation employees who join the New SRO will be compensated wholly consistent with their compensation at the time of closing of the Transaction. Reductions in workforce, if any, will be limited to attrition during the first two years after closing of the Transaction. The New SRO will be responsible for the costs associated with any reductions in workforce.

Technology

NYSE Group has agreed to support and maintain, consistent with its past practice, its existing technology systems that support member firm regulation for a fixed transition period of one year from the closing of the Transaction while such systems are migrated to the New SRO. NYSE Group and NASD expect to work in good faith to transfer owned and licensed intellectual property and related assets and migrate all usable and transferable portions of the technology systems transferred within the one year period. NASD will compensate NYSE Group for its support of these systems. NASD will be responsible for any costs associated with the termination of any transferred technology systems. Any services provided by NYSE Group to the New SRO or by the New SRO to NYSE Group during the one year period following the closing of the Transaction shall be based on direct expense hours and actual rates incurred plus a 25% mark-up.

Sublease of Office Space

The New SRO will sublease or license from NYSE Group certain of the office space currently used by NYSE Regulation. This office space consists of approximately 76,000 square feet located at 14 Wall Street and 90,800 square feet at 20 Broad Street in New York City. The sublease or license will be based on pre-existing cost allocations without mark-up. NYSE Group and the New SRO will enter into a five-year services agreement not to exceed $10 million per year for the sublease or license of the space and to pay for the related security services and other reasonable direct and allocated occupancy and security costs.

Composition of the Board of Governors during the Transitional Period

As of the date of this proxy statement, the NASD Board of Governors consists of the following individuals: Mary L. Schapiro, William C. Alsover, John W. Bachmann, Charles A. Bowsher, John J. Brennan, Richard F. Brueckner, James E. Burton, Sir Brian Corby, Admiral Tyler F. Dedman, U.S. Navy (Retired), William H. Heyman, Brian J. Kovack, Judith R. MacDonald, John Rutherfurd, Jr., Joel Seligman, John S. Simmers and Sharon P. Smith.

During the Transitional Period, the Board will consist of 23 governors as follows: (1) eleven of the governors will be "Public Governors", (2) ten of the governors will be "Industry Governors" and (3) two of the governors will initially be Richard G. Ketchum, Chief Executive Officer of NYSE Regulation and Mary L. Schapiro, Chief Executive Officer of NASD.

The eleven Public Governors will have no material business relationship with a broker or dealer or a self-regulatory organization registered under the Exchange Act.

Of the ten Industry Governors, (1) three will be registered with a member that employs 500 or more registered persons (the "Large Firm Governors"); (2) one will be registered with a member that employs at least 151 and no more than 499 registered persons (the "Mid-Size Firm Governor");

(3) three will be registered with a member that employs at least 1 and no more than 150 registered persons (the "Small Firm Governors"); (4) one will be associated with a floor member of the New York Stock Exchange (the "Floor Member Governor"); (5) one will be associated with an independent dealer or insurance affiliate (the "Independent Dealer/Insurance Affiliate Governor"); and (6) one will be associated with an investment company affiliate (the "Investment Company Affiliate Governor").

The Industry Governors and Public Governors will be appointed or nominated during the Transitional Period as follows:

- The three Small Firm Governors will be nominated by the NASD Board and elected by members that have at least one and no more than 150 registered persons; provided that members of that size also can nominate such candidates.
- The one Mid-Size Firm Governor will be nominated jointly by the NYSE Group Board and the NASD Board and elected by members that have at least 151 and no more than 499 registered persons; provided that members of that size also can nominate such candidates.
- The three Large Firm Governors will be nominated by the NYSE Group Board and elected by members that have 500 or more registered persons; provided that members of that size also can nominate such candidates.
- Five Public Governors will be appointed by the NYSE Group Board.
- Five Public Governors will be appointed by the NASD Board.
- One Public Governor will be appointed jointly by the NYSE Group Board and the NASD Board.
- The one Floor Member Governor will be appointed by the NYSE Group Board.
- The one Independent Dealer/Insurance Affiliate Governor will be appointed by the NASD Board.
- The one Investment Company Affiliate Governor will be appointed jointly by the NYSE Group Board and the NASD Board.

Effective as of closing of the Transaction, the NYSE Group Board and the NASD Board in office prior to the closing will appoint the Public Governors and Industry Governors they, either individually or jointly, have the power to appoint. The Public Governors will hold office for the Transitional Period. The three Large Firm Governors, three Small Firm Governors and one Mid-Size Governor will be elected as Governors at the first annual meeting of members following the closing, which is expected to be held within ninety days after closing of the Transaction and will hold office until the first annual meeting of members following the Transitional Period. During the interim period from closing of the Transaction until the annual meeting, these seven seats will be filled by three Interim Industry Governors appointed by the NASD Board prior to the closing of the Transaction from industry governors currently on the NASD Board, three Interim Industry Governors appointed by the Board of NYSE Group and one Interim Industry Governor jointly appointed by the Board of NYSE Group and the NASD Board prior to the closing of the Transaction.

As a result of the By-Law amendments, members will no longer have the ability to vote for all Board candidates in elections, but will have an opportunity to vote on designated seats on the Board. Specifically, firms will vote for industry nominees that are similar in size to their own firm. This means that small firms and large firms will vote for candidates running for the seats reserved for their firm size and the mid-sized firms will likewise vote for the mid-sized firm seat. All other Board seats will be appointed as described above. All members will continue to have the ability to vote on any future By-Law amendments, as well as in district elections. In addition, the New SRO will continue NASD's current practice of subject-matter expert standing committees and NASD's current notice and comment process for rule-making.

The membership of committees of the New SRO Board during the Transitional Period generally will reflect the proportion of NYSE Group and NASD appointees/nominees on the New SRO Board during the Transitional Period.

The New SRO Board will have a Lead Governor who will preside over executive sessions of the New SRO Board in the event the Non-Executive Chairman is recused. The Lead Governor will be selected by the New SRO Board, after consultation with the Chief Executive Officer. The Chief Executive Officer, Non-Executive Chairman and the Lead Governor will have the authority to call meetings of the New SRO Board. Both the Chief Executive Officer and Non-Executive Chairman, and for matters from which the Chief Executive Officer and Non-Executive Chairman are recused from considering, the Lead Governor, will have the authority to place items on the New SRO Board agendas.

Governor Vacancies during the Transitional Period

In the event of a vacancy in the governor position held by the Chief Executive Officer of NYSE Regulation during the Transitional Period, the then Chief Executive Officer of NYSE Regulation will serve as a governor for the remainder of the Transitional Period. If the Chief Executive Officer of NYSE Regulation as of closing of the Transaction ceases to occupy the office of Non-Executive Chairman for any reason during the Transitional Period, then his successor as Non-Executive Chairman shall be selected by and from a committee comprised of the Governors that were appointed or nominated by the NYSE Group Board with the exception that those Governors that also serve as NYSE Group directors may not become Non-Executive Chairman nor may his successor as Chief Executive Officer of NYSE Regulation become Non-Executive Chairman.

In the event of any vacancy among the Large Firm Governors, the Mid-Size Firm Governor or the Small Firm Governors during the Transitional Period, such vacancy shall only be filled by, and nominations for persons to fill such vacancy shall be made by, a committee of the Board composed of the other Governors appointed or nominated by the NYSE Group Board in the case of a Large Firm Governor vacancy, such vacancy shall only be filled by the Board, and nominations for persons to fill such vacancy shall be made by the Nominating Committee, in the case of a Mid-Size Firm Governor vacancy or such vacancy shall only be filled by, and nominations for persons to fill such vacancy shall be made by, a committee of the Board composed of the other Governors appointed or nominated by the NASD Board in the case of a Small Firm Governor vacancy. In the event the remaining term of office of any such governor is more than twelve months, nominations shall be made as set forth above in this paragraph, but such vacancy will be filled by the NASD members entitled to vote on such governor position at a meeting of such members called to fill the vacancy.

In the event of any vacancy among the Floor Member Governor, the Investment Company Affiliate Governor or the Independent Dealer/Insurance Affiliate Governor during the Transitional Period, such vacancy shall only be filled by, and nominations for persons to fill such vacancy shall be made by, a committee of the Board composed of the other Governors appointed or nominated by the NYSE Group Board in the case of a Floor Member Governor vacancy, such vacancy shall only be filled by the Board, and nominations for persons to fill such vacancy shall be made by the Nominating Committee, in the case of an Investment Company Affiliate Governor vacancy or such vacancy shall only be filled by, and nominations for persons to fill such vacancy shall be made by, a committee of the Board composed of other Governors appointed or nominated by the NASD Board in the case of an Independent Dealer/Insurance Affiliate Governor vacancy.

In the event of any vacancy among those Public Governors appointed by the NYSE Group Board, such vacancy will only be filled by, and nominations for persons to fill such vacancy shall be made by, a committee of the New SRO Board composed of the other Governors appointed or nominated by the NYSE Group Board. In the event of any vacancy among those Public Governors appointed by the NASD Board, such vacancy will only be filled by, and nominations for persons to fill such vacancy shall

be made by, a committee of the Board comprised of the other Governors appointed or nominated by the NASD Board. In the event of any vacancy of the Public Governor position jointly appointed by the NYSE Group Board and the NASD Board, such vacancy shall only be filled by the Board, and nominations for persons to fill such vacancy shall be made by the Nominating Committee.

Composition of the New SRO Board after the Transitional Period

Upon the expiration of the Transitional Period, the term of office of the Chief Executive Officer of NYSE Regulation as a member of the Board will automatically terminate and the authorized number of members of the Board will be reduced by one.

As of the first annual meeting of members following the Transitional Period, the Large Firm Governors, the Mid-Size Firm Governor and the Small Firm Governors will be elected into three classes. The composition of the classes will be arranged as follows:

- the first class, being comprised of one Large Firm Governor and one Small Firm Governor, will be elected for a term of office expiring at the first succeeding annual meeting of members;
- the second class, being comprised of one Large Firm Governor, one Mid-Size Firm Governor and one Small Firm Governor, will be elected for a term of office expiring at the second succeeding annual meeting of members; and
- the third class, being comprised of one Large Firm Governor and one Small Firm Governor, will be elected for a term of office expiring at the third succeeding annual meeting of members.

While these classes are designed to ensure staggered board seats, at no time will there be less than ten Industry Governor positions on the Board of Governors. At each annual election following the first annual meeting of members after the Transitional Period, Large Firm Governors, Small Firm Governors and Mid-Size Firm Governors will be elected for a term of three years to replace those whose terms expire.

As of the first annual meeting of members following the Transitional Period, the Public Governors, the Floor Member Governor, the Independent Dealer/Insurance Affiliate Governor and the Investment Company Affiliate Governor (the "Appointed Governors") will be divided by the Board into three classes, as equal in number as possible, with the first class holding office until the first succeeding annual meeting of members, the second class holding office until the second succeeding annual meeting of members and the third class holding office until the third succeeding annual meeting of members. Each class will initially contain as equivalent a number as possible of Appointed Governors who were members of the Board of Governors appointed or nominated by the NYSE Group Board or are successors to such governor positions, on the one hand, and Appointed Governors who were members of the Board of Governors appointed or nominated by the NASD Board or are successors to such governor positions, on the other hand, to the extent the Board of Governors determines such persons are to remain Governors after the Transitional Period. At each annual election following the first annual meeting of members following the Transitional Period, Appointed Governors will be appointed by the Board for a term of three years to replace those whose terms expire.

Role and Composition of the Nominating Committee

The Nominating Committee will be a committee of the New SRO Board and will replace the current National Nominating Committee. For the first annual meeting following the closing of the Transaction, nominations for the seven elected industry seats will not be made by the Nominating Committee, but instead by the Board of Governors of NASD and the NYSE Group Board prior to the closing of the Transaction. In addition, prior to the closing the Board of Governors of NASD and the NYSE Group Board will identify and appoint persons for the eleven public seats and three remaining industry seats.

During the Transitional Period, the Nominating Committee will be responsible solely for nominating persons to fill vacancies in governor seats for which the full Board has the authority to fill. Following the Transitional Period, the Nominating Committee will be responsible for nominating persons for appointment or election to the Board, as well as nominating persons to fill vacancies in appointed or elected governor seats.

During the Transitional Period, members of the Nominating Committee will be appointed jointly by the New SRO Chief Executive Officer and the Chief Executive Officer of NYSE Regulation as of closing of the transaction (or his duly appointed successor as Chair of the Board), subject to ratification of the appointees by the New SRO Board. Following the Transitional Period, the composition of the Nominating Committee will be determined by the New SRO Board. At all times, the number of Public Governors on the Nominating Committee must equal or exceed the number of Industry Governors on the Nominating Committee. In addition, the Nominating Committee must at all times be comprised of a number of governors that is a minority of the entire Board. The New SRO Chief Executive Officer may not be a member of the Nominating Committee.

Organization and Management

After closing of the Transaction, Richard G. Ketchum will serve as Non-Executive Chairman of the New SRO for a term of three years. Mr. Ketchum, as the Non-Executive Chairman of the New SRO will be the Chair of the Board's integration committee for a period not to exceed one year, unless the Board affirmatively votes to extend the Committee's term. Members of the Board of Directors of NYSE Group will be permitted to serve on the New SRO Board, so long as (1) no more than a total of two governors will simultaneously serve on the New SRO Board and NYSE Group Board, (2) they must be independent directors of NYSE Group Board, (3) they may not serve as chairs of any New SRO Board Committees, and (4) they may not serve as Chair of the New SRO Board.

Mary L. Schapiro will serve as Chief Executive Officer of the New SRO. As Chief Executive Officer, Ms. Schapiro will have responsibility for integration and ongoing operations.

Regulatory Filings and Approvals Required to Complete the Transaction

NASD and NYSE Group expect to file notification reports with the Department of Justice and the Federal Trade Commission under the HSR Act. The waiting period for such a filing will terminate 30 calendar days after the filing, unless the waiting period is extended. NASD believes that the completion of the Transaction will not violate the antitrust laws.

The amendments to the By-Laws will be submitted to the SEC for approval.

The Transaction is conditioned upon a favorable ruling by the IRS that the Transaction will not affect the tax-exempt status of NASD or NASDR. NASD and NYSE Group will seek to satisfy all regulatory filing obligations and observe any required waiting periods prior to the completion of the Transaction.

Conditions to Completion of the Transaction

Completion of the Transaction is subject to the satisfaction or waiver of a number of conditions, including the following:

- The definitive agreements between NASD and the NYSE Group must have been executed.
- The amendments to the By-Laws must have been approved by the requisite affirmative vote of the NASD members in accordance with law of the State of Delaware and the By-Laws.
- Any waiting period under the HSR Act must have expired or been terminated.
- The SEC must not have indicated, formally or informally, that it will seek to prevent the Transaction and the SEC must have approved the amendments to the By-Laws in a published SEC Release.

- Each of NASD, NYSE Regulation and NYSE Group must have received all necessary consents and approvals of governmental authorities.

- Each of NASD, NYSE Regulation and NYSE Group must have complied in all material respects with its covenants and agreements.

- The IRS must have issued a ruling that the Transaction will not affect NASD's or NASDR's tax-exempt status.

Special Member Payment and Effect of the Transaction on the Members

The consolidation will reduce the costs of regulation. In connection with the Transaction, a one-time special member payment will be made to NASD members. The special member payment will be $35,000 per NASD member. In addition, we will discount the annual gross income assessment to members for a period of five years, subject to annual Board approval. Each firm would receive a discount of $1,200 per year, which is the minimum annual gross income assessment charge and the total amount of the annual gross income assessment that approximately 2,400 member firms pay. As a result of this discount, the approximately 2,400 member firms currently paying the minimum would pay no gross income assessments charge over the five-year period. It is expected that we will benefit from economies of scale and will be able to reduce regulatory fees starting in the third year after closing of the Transaction.

The special member payment of $35,000 per member will be payable as of the close of business on the closing date of the Transaction to NASD members of record as of the close of business on the business day next immediately preceding the day of closing of the Transaction.

For U.S. federal income tax purposes, the special member payment will be includible in a member's taxable income as ordinary income. A discount in the annual gross income assessment will have no consequence for U.S. federal income tax purposes unless it is effected by means of a rebate of amounts previously deducted, in which case the rebate will be includible in a member's taxable income as ordinary income.

Firms that today are regulated by both NASD and NYSE Regulation will benefit from the elimination of the current duplication of regulatory review of these firms. The Transaction will further benefit all NASD members as it will streamline the broker-dealer regulatory system, combine technologies, and permit the establishment of a single set of rules and group examiners with complementary areas of expertise in a single organization – all of which will serve to enhance oversight of U.S. securities firms and help ensure investor protection. Moreover, we are committed to reducing regulatory costs and burdens for firms of all sizes through greater regulatory efficiency.

As a result of the By-Law amendments, members will no longer have the ability to vote for all Board candidates in elections, but will have an opportunity to vote on designated seats on the Board. Specifically, firms will vote for industry nominees that are similar in size to their own firm. This means that small firms and large firms will vote for candidates running for the seats reserved for their firm size and the mid-sized firms will likewise vote for the mid-sized firm seat. All other Board seats will be appointed as described elsewhere in this proxy statement. All members will continue to have the ability to vote on any future By-Law amendments, as well as in district elections. In addition, the New SRO will continue NASD's current practice of subject-matter expert standing committees and NASD's current notice and comment process for rule-making.

To further encourage small firm input and participation, the organization has enhanced the existing Small Firm Advisory Board, making half of the seats elected. The Small Firm Advisory Board will continue to review NASD rules and make recommendations to the Board of Governors.

INFORMATION CONCERNING THE SPECIAL MEETING

Date, Time and Place of the Special Meeting

This proxy statement is furnished to you in connection with the solicitation of proxies by the NASD Board for the special meeting of the NASD members to be held the NASD Visitors Center at 1735 K Street NW, Washington, D.C. 20006 on January 19, 2007, at 10:00 a.m., Eastern Time, or any postponement or adjournment of the meeting. This proxy statement, the Notice of Special Meeting and the accompanying form of proxy card are first being mailed to the NASD members on or about December 14, 2006.

Purpose of the Special Meeting

At the special meeting, you will be asked:

- to consider and vote upon a proposal to approve amendments to the By-Laws to implement governance and related changes to accommodate the consolidation of the member firm regulatory functions of NYSE Regulation with NASD, which amendments will become effective on the closing of the Transaction; and

- to transact any other business that may properly come before the special meeting or any adjournment or postponement of the special meeting.

Record Date; Voting Rights; Quorum

The record date is December 8, 2006. Subject to applicable law, all NASD members of record at the close of business on the record date, December 8, 2006, are entitled to notice of, and to one vote at, the special meeting. The presence, in person or by proxy, of one-third of the NASD members of record as of the record date is required to constitute a quorum for the transaction of business.

Voting and Revocation of Proxies

You may vote in person or by proxy. To grant a proxy to vote, you can use one of the following three methods: (1) call toll free 1-877-381-4017; (2) log onto the website at http://proxy.georgeson.com; or (3) mark, sign and date your proxy card (in the form accompanying this proxy statement) and return it promptly in the postage pre-paid enclosed envelope. You must mail or deliver the proxy card so that it will be received on or before midnight, Eastern Time, on January 18, 2007. If you grant a proxy by phone or internet, do not mail the proxy card.

A form of proxy card for your use at the special meeting accompanies this proxy statement. All properly executed proxies that are received prior to or at the special meeting and not revoked will be voted at the special meeting in the manner specified. If you execute and return a proxy and do not specify otherwise, your proxy will be voted **"FOR"** approval of the amendments to the By-Laws in accordance with the recommendation of the NASD Board.

If you have given a proxy pursuant to a proxy card distributed by NASD or electronically in the manner described in this proxy statement, you may nonetheless revoke your proxy by attending the special meeting and voting in person. In addition, you may revoke any such proxy you give at any time before the special meeting by delivering to our Corporate Secretary a written statement revoking it or by delivering a duly executed proxy bearing a later date, or granting a proxy electronically at a later date. If you have delivered a proxy to us pursuant to a proxy card distributed by NASD or electronically in the manner described in this proxy statement, your attendance at the special meeting will not in and of itself constitute a revocation of your proxy.

We understand that certain groups or individuals may have asked you to sign a purported irrevocable proxy and power of attorney. These groups and individuals are not acting at the direction, or with the support, of NASD, the NASD Board or NASD management, and such document is not being distributed by or on behalf of NASD, the NASD Board or NASD management. If you sign such a document, it is possible that you may not have the ability to change your vote after you sign it. Accordingly, in order to preserve your ability to change your vote, we urge you to grant a proxy only using a proxy card distributed by NASD or electronically in the manner described in this proxy statement.

If a quorum is present, such that the special meeting may proceed, the amendments to the By-Laws must be approved by a majority of those present, in person or by proxy, at the special meeting and entitled to vote on the matter. If you fail to either send in your proxy or grant a proxy electronically, it will not have any effect on such a vote if a quorum has otherwise been established.

Solicitation of Proxies

We will bear the cost of the solicitation by NASD of proxies. We will solicit proxies initially by mail. Further solicitation may be made by our governors, officers and employees personally, by telephone or otherwise, but they will not be specifically compensated for these services. We have also retained Georgeson to coordinate and assist in the solicitation of proxies and we will pay them a customary fee for such services. We do not intend to bear the cost of solicitations of proxies by any other parties.

Other Matters

We do not know of any matters other than those described in this proxy statement that may come before the special meeting. If any other matters are properly presented to the special meeting for action, absent instructions on any proxy to the contrary, we intend that the persons named in the enclosed form of proxy card will vote in accordance with their best judgment. These matters may include an adjournment or postponement of the special meeting from time to time if the NASD Board so determines, including an adjournment in order to solicit additional votes in favor of the proposal to amend the NASD By-Laws in the event there are insufficient votes to approve the proposal at the special meeting. If any adjournment or postponement is made, we may solicit additional proxies during the adjournment period.

Your vote is important. Please provide your proxy promptly, even if you plan to attend the special meeting in person.

For additional information regarding the special meeting or this solicitation please contact our Proxy Solicitor for the Special Meeting at:

Georgeson
17 State Street
New York, NY 10004
1-866-647-8875

CHANGES TO THE NASD BY-LAWS

Description of the proposed changes and comparison to the current NASD By-Laws

We are seeking your approval of the amendments to the NASD By-Laws. These amendments will provide us with an appropriate corporate governance structure, enabling us to combine certain functions of NYSE Regulation from NYSE Group. If the proposal to amend the By-Laws is approved at the special meeting of members, the amendments will take effect at the closing of the Transaction, with certain aspects being operative during the Transitional Period and certain aspects becoming operative after the Transitional Period. The following summarizes the material proposed changes as compared to the current By-Laws and the timing of their effectiveness. The following is only a summary and is qualified in its entirety to the proposed amendments to the By-Laws attached hereto as Appendix A and members are advised to read Appendix A hereto. There are also certain other proposed changes reflected in Appendix A, including, for example, the elimination of references to the Nasdaq Stock Market, Inc. Furthermore, as part of the proposed changes to the By-Laws, each of the references to "the NASD" or "NASD" in the By-Laws, even in sections of the By-Laws not included in Appendix A, will be replaced with "the Corporation" in contemplation of a change in the name of the corporation. In addition to the foregoing, as part of the proposed changes to the By-Laws, each of the references to the "Rules of the Association" in the By-Laws, even in sections of the By-Laws not included in Appendix A, will be replaced with the "Rules of the Corporation". If the amendments to the By-Laws are approved, corresponding changes will be made to NASD's Certificate of Incorporation.

Topic	Current By-Laws	By-Laws Effective at Closing and for the Transitional Period	By-Laws Effective at the Expiration of the Transitional Period
Composition and Qualification of the Board	The Board consists of no fewer than 15 nor more than 25 Governors, comprising (i) the Chief Executive Officer of the NASD, (ii) if the Board of Governors determines, from time to time, in its sole discretion, that the appointment of a second officer of the NASD to the Board of Governors is advisable, a second officer of the NASD, (iii) the President of NASD Regulation, (iv) the Chair of the National Adjudicatory Council, and (v) no fewer than 12 and no more than 22 Governors elected by the members of the NASD. The Governors elected by the members of the NASD include a representative of an issuer of investment company shares or an affiliate of such an issuer, a representative of an	As of Closing, and for the Transitional Period, the Board consists of 23 authorized members, consisting of (i) the Chief Executive Officer of the NASD, (ii) the Chief Executive Officer of NYSE Regulation, Inc., (iii) eleven Public Governors, (iv) a Floor Member Governor, an Independent Dealer/ Insurance Affiliate Governor and an Investment Company Affiliate Governor and (v) three Small Firm Governors, one Mid-Size Firm Governor and three Large Firm Governors; provided, however that the Board will not include such Small Firm Governors, Mid-Size Firm Governor or Large Firm Governors, but rather will include three persons, who immediately prior to the Closing are Industry Governors,	Same as By-Laws for the Transitional Period, except that: (i) the Chief Executive Officer of NYSE Regulation, Inc. is no longer a Governor; (ii) the total number of Governors is determined by the Board of Governors, with such number being no fewer than 16, nor more than 25; and (iii) the number of Public Governors is determined by the Board of Governors, provided such number must exceed the number of Industry Governors.

Topic	Current By-Laws	By-Laws Effective at Closing and for the Transitional Period	By-Laws Effective at the Expiration of the Transitional Period
	insurance company, a representative of a national retail firm, a representative of a regional retail or independent financial planning member firm, a representative of a firm that provides clearing services to other NASD members, and a representative of an NASD member having not more than 150 registered persons. The number of Non-Industry Governors must exceed the number of Industry Governors. If the number of Industry and Non-Industry Governors is 13–15, the Board must include at least four Public Governors. If the number of Industry and Non-Industry Governors is 16–17, the Board must include at least five Public Governors. If the number of Industry and Non-Industry Governors is 18–23, the Board must include at least six Public Governors.	selected by the Board in office prior to the Closing, three persons, who immediately prior to the Closing qualified as Industry Governors pursuant to the By-Laws in existence prior to the Closing, selected by the Board of Directors of NYSE Group, Inc., and one person, who immediately prior to the Closing qualified as an Industry Governor pursuant to the By-Laws in existence prior to the Closing, selected by the Board of Directors of NYSE Group, Inc. and the Board of Governors in office prior to the Closing jointly, until the election of such Small Firm Governors, Mid-Size Firm Governor and Large Firm Governors at the first annual meeting of members following the Closing. [NOTE: To allow for the possibility of a contested election, the nominees for the Small Firm Governor, Mid-Size Firm Governor or Large Firm Governor will be voted upon at an annual meeting of members which shall be held as soon as practicable after the closing of the Transaction and is expected to be held within ninety days of the closing of the Transaction.]	
Term of Office of Governors	The Chief Executive Officer and, if appointed, the second officer of the NASD, and the President of NASD Regulation serve as Governors until a successor is elected, or until death, resignation, or removal.	The Chief Executive Officer serves as a Governor until a successor is elected, or until death, resignation, or removal. The Chief Executive Officer of NYSE Regulation, Inc. as of Closing serves as a	The Chief Executive Officer serves as a Governor until a successor is elected, or until death, resignation, or removal. Public Governors and the Floor Member Governor, the Independent Dealer

Topic	Current By-Laws	By-Laws Effective at Closing and for the Transitional Period	By-Laws Effective at the Expiration of the Transitional Period
	The Chair of the National Adjudicatory Council serves as a Governor for a term of one year, or until a successor is duly elected and qualified, or until death, resignation, disqualification, or removal. The Governors elected by the members of the NASD are divided into three classes and hold office for a term of no more than three years, such term being fixed by the Board at the time of the nomination or certification of each such Governor, or until a successor is duly elected and qualified, or until death, resignation, disqualification, or removal.	Governor during the Transitional Period, until death, resignation, or removal. Effective as of Closing, the Board of Directors of NYSE Group, Inc. appoints the NYSE Public Governors, the Board in office prior to the Closing appoints the NASD Public Governors and the Board of Directors of NYSE Group, Inc. and the Board in office prior to the Closing jointly appoint the Joint Public Governor. Effective as of Closing, the Board of Directors of NYSE Group, Inc. appoints the Floor Member Governor, the Board of Governors in office prior to the Closing appoints the Independent Dealer/Insurance Affiliate Governor and the Board of Directors of NYSE Group, Inc. and the Board of Governors in office prior to the Closing jointly appoint the Investment Company Affiliate Governor. The Public Governors and the Floor Member Governor, the Investment Company Affiliate Governor and the Independent Dealer/Insurance Affiliate Governor appointed in accordance with the preceding paragraphs hold office for the Transitional Period, or until death, resignation, disqualification, or removal.	/Insurance Affiliate Governor and the Investment Company Affiliate Governor (the "Appointed Governors") are appointed by the Board. As of the first annual meeting of members following the Transitional Period, the Appointed Governors are divided by the Board into three classes, as equal in number as possible, with the first class holding office until the first succeeding annual meeting of members, the second class holding office until the second succeeding meeting of members and the third class holding office until the third succeeding annual meeting of members, or until a successor is duly appointed and qualified, or until death, resignation, disqualification, or removal. Each class initially contains as equivalent a number as possible of Appointed Governors who were members of the NYSE Group Committee during the Transitional Period or are successors to such Governor positions, on the one hand, and Appointed Governors who were members of the NASD Group Committee during the Transitional Period or are successors to such Governor positions, on the other hand, to the extent the Board determines such persons are to remain Governors after the

Topic	Current By-Laws	By-Laws Effective at Closing and for the Transitional Period	By-Laws Effective at the Expiration of the Transitional Period
		Three Large Firm Governors, three Small Firm Governors and one Mid-Size Governor are elected as Governors at the first annual meeting of members following the Closing (the "Initial Member Elected Governors"). The Initial Member Elected Governors hold office until the first annual meeting of members following the Transitional Period, or until a successor is duly elected and qualified, or until death, resignation, disqualification, or removal. Upon the expiration of the Transitional Period, the term of office of the Chief Executive Officer of NYSE Regulation, Inc. as a member of the Board automatically, and without any further action, terminates, such person no longer is a member of the Board and the authorized number of members of the Board automatically is reduced by one.	Transitional Period. At each annual election following the first annual meeting of members following the Transitional Period, Appointed Governors are appointed by the Board for a term of three years to replace those whose terms expire. As of the first annual meeting of members following the Transitional Period, the Large Firm Governors, the Mid-Size Firm Governor and the Small Firm Governors are divided into three classes, as equal in number as possible, with the first class, being comprised of one Large Firm Governor and one Small Firm Governor, holding office until the first succeeding annual meeting of members, the second class, being comprised of one Large Firm Governor, one Mid-Size Firm Governor and one Small Firm Governor, holding office until the second succeeding annual meeting of members and the third class, being comprised of one Large Firm Governor and one Small Firm Governor, holding office until the third succeeding annual meeting of members, or until a successor is duly elected and qualified, or until death, resignation, disqualification, or removal. At each annual election following the first annual meeting of members following the Transitional

Topic	Current By-Laws	By-Laws Effective at Closing and for the Transitional Period	By-Laws Effective at the Expiration of the Transitional Period
			Period, Large Firm Governors, Small Firm Governors and the Mid-Size Firm Governor are elected for a term of three years to replace those whose terms expire.
Filling of Vacancies	If an elected Governor position becomes vacant, whether because of death, disability, disqualification, removal, or resignation, the National Nominating Committee nominates, and the Board elects by majority vote of the remaining Governors then in office, a person satisfying the classification (Industry, Non-Industry, or Public Governor) for the governorship to fill such vacancy, except that if the remaining term of office for the vacant Governor position is not more than six months, no replacement is required. If the remaining term of office for the vacant Governor position is more than one year, the Governor elected by the Board to fill such position stands for election in the next annual election.	In the event the Chief Executive Officer of NYSE Regulation, Inc. as of Closing no longer serves as a Governor during the Transitional Period, the then Chief Executive Officer of NYSE Regulation, Inc. serves as a Governor for the remainder of the Transitional Period, until death, resignation or removal. In the event of any vacancy among the NYSE Public Governors, the Joint Public Governor or NASD Public Governors during the Transitional Period, such vacancy is only filled by, and nominations for persons to fill such vacancy are made by, the NYSE Group Committee in the case of a vacant NYSE Public Governor position, such vacancy is only filled by the Board, and nominations for persons to fill such vacancy are made by the Nominating Committee, in the case of a vacant Joint Public Governor position or such vacancy is only filled by, and nominations for persons to fill such vacancy are made by, the NASD Group Committee in the case of a vacant NASD Public Governor position.	In the event of any vacancy among the Large Firm Governors, the Mid-Size Firm Governor or the Small Firm Governors, such vacancy is only filled by the Large Firm Governor Committee in the case of a Large Firm Governor vacancy, the Board in the case of a Mid-Size Firm Governor vacancy or the Small Firm Governor Committee in the case of a Small Firm Governor vacancy; provided, however, that in the event the remaining term of office of any Large Firm, Mid-Size Firm or Small Firm Governor position that becomes vacant is for more than 12 months, such vacancy is filled by the members of the New SRO entitled to vote thereon at a meeting thereof convened to vote thereon. All other vacancies are filled by the Board.

Topic	Current By-Laws	By-Laws Effective at Closing and for the Transitional Period	By-Laws Effective at the Expiration of the Transitional Period
		In the event of any vacancy among the Floor Member Governor, the Investment Company Affiliate Governor or the Independent Dealer/ Insurance Affiliate Governor during the Transitional Period, such vacancy is only filled by, and nominations for persons to fill such vacancy are made by, the NYSE Group Committee in the case of a Floor Member Governor vacancy, such vacancy is only filled by the Board, and nominations for persons to fill such vacancy are made by the Nominating Committee, in the case of an Investment Company Affiliate Governor vacancy or such vacancy is only filled by, and nominations for persons to fill such vacancy are made by, the NASD Group Committee in the case of an Independent Dealer/Insurance Affiliate Governor vacancy. In the event of any vacancy among the Large Firm Governors, the Mid-Size Firm Governor or the Small Firm Governors during the Transitional Period, such vacancy is only filled by, and nominations for persons to fill such vacancy are made by, the NYSE Group Governor Committee in the case of a Large Firm Governor vacancy, such vacancy is only filled by the Board, and nominations for persons to fill such vacancy are made by the Nominating Committee, in the case of the Mid-Size Firm Governor vacancy or such vacancy is only filled by, and nominations for persons to fill such vacancy are made by,	

Topic	Current By-Laws	By-Laws Effective at Closing and for the Transitional Period	By-Laws Effective at the Expiration of the Transitional Period
		the NASD Governor Committee in the case of a Small Firm Governor vacancy; provided, however, that in the event the remaining term of office of any Large Firm, Mid-Size Firm or Small Firm Governor position that becomes vacant is for more than 12 months, nominations shall be made as set forth above in this paragraph, but such vacancy is filled by the members of the NASD entitled to vote thereon at a meeting thereof convened to vote thereon.	
Nominations	The National Nominating Committee, which is not a committee of the Board, nominates and, in the event of a contested election, may support: Industry, Non-Industry, and Public Governors for each vacant or new Governor position on the NASD Board for election by the membership; Industry, Non-Industry, and Public Directors for each vacant or new position on the NASD Regulation Board and the NASD Dispute Resolution Board for election by the stockholder; and Industry, Non-Industry, and Public members for each vacant or new position on the National Adjudicatory Council for appointment by the NASD Regulation Board.	In the case of the first annual meeting of members following the Closing, nominations are by the Board of Directors of NYSE Group, Inc. with respect to Large Firm Governors, jointly by the Board of Directors of NYSE Group, Inc. and the Board in office prior to the Closing with respect to the Mid-Size Firm Governor and by the Board in office prior to the Closing with respect to Small Firm Governors.	The Nominating Committee, which is a committee of the Board, nominates and, in the event of a contested election, may support: Large Firm, Mid-Size Firm, Small Firm, Public, Floor Member, Independent Dealer/Insurance Affiliate and Investment Company Affiliate Governors for each vacant or new Governor position on the New SRO Board; Industry and Public Directors for each vacant or new position on the NASD Regulation Board and the NASD Dispute Resolution Board for election by the stockholder; and Industry and Public members for each vacant or new position on the National Adjudicatory Council for appointment by the NASD Regulation Board.

Topic	Current By-Laws	By-Laws Effective at Closing and for the Transitional Period	By-Laws Effective at the Expiration of the Transitional Period
Composition and Qualifications of the Nominating Committee	The National Nominating Committee consists of no fewer than six and no more than nine members. The number of Non-Industry committee members equals or exceeds the number of Industry committee members. If the National Nominating Committee consists of six members, at least two must be Public committee members. If the National Nominating Committee consists of seven or more members, at least three must be Public committee members. No officer or employee of the NASD serves as a member of the National Nominating Committee in any voting or non-voting capacity. No more than three of the National Nominating Committee members and no more than two of the Industry committee members are current members of the NASD Board. A National Nominating Committee member may not simultaneously serve on the National Nominating Committee and the Board, unless such member is in his or her final year of service on the Board, and following that year, that member may not stand for election to the Board until such time as he or she is no longer a member of the National Nominating Committee.	The Nominating Committee is jointly populated by the Chief Executive Officer and the Chief Executive Officer of NYSE Regulation, Inc. as of Closing (or his duly appointed or elected successor as Chair of the Board), subject to ratification of the appointees by the Board. The number of Public Governors on the Nominating Committee equals or exceeds the number of Industry Governors on the Nominating Committee. The Nominating Committee is at all times comprised of a number of members which is a minority of the entire Board and the Chief Executive Officer may not be a member of the Nominating Committee.	The Nominating Committee consists of such number of members of the Board as the Board determines from time to time. The number of Public Governors on the Nominating Committee equals or exceeds the number of Industry Governors on the Nominating Committee. The Nominating Committee is at all times comprised of a number of members which is a minority of the entire Board and the Chief Executive Officer may not be a member of the Nominating Committee.

Topic	Current By-Laws	By-Laws Effective at Closing and for the Transitional Period	By-Laws Effective at the Expiration of the Transitional Period
Required Board Committees	NASD is required to have an Audit Committee and a National Nominating Committee.	New SRO is required to have the following committees of the Board: the NASD Group Committee; the NYSE Group Committee; the Small Firm Governor Committee; and the Large Firm Governor Committee, which have the authority described above in "Filling of Vacancies" and below in "Chair". New SRO also is required to have Audit, Finance and Nominating Committees and, during the first year of the Transitional Period or as may be extended thereafter by the Board, an Integration Committee.	New SRO is required to have the following committees of the Board: the Small Firm Governor Committee; and the Large Firm Governor Committee, which have the authority described above in "Filling of Vacancies". New SRO also is required have Audit, Finance and Nominating Committees.
Composition of Board Committees	Unless otherwise provided in the By-Laws, any committee having the authority to exercise the powers and authority of the Board has a percentage of Non-Industry committee members at least as great as the percentage of Non-Industry Governors on the Board and a percentage of Public committee members at least as great as the percentage of Public Governors on the Board.	The NASD Group Committee, the NYSE Group Committee, the Small Firm Governor Committee and the Large Firm Governor Committee are composed as described below in the description of such defined terms. Unless otherwise provided in the By-Laws, any other committee having the authority to exercise the powers and authority of the Board has a number of Public Governors as members thereof in excess of the number of Industry Governors which are members thereof. In addition, any committee of the Board having the authority to exercise the powers and authority of the Board (with the exception of the Large Firm Governor Committee, the Small Firm	The Small Firm Governor Committee and the Large Firm Governor Committee are composed as described below in the description of such defined terms. Unless otherwise provided in the By-Laws, any other committee having the authority to exercise the powers and authority of the Board has a number of Public Governors as members thereof in excess of the number of Industry Governors which are members thereof.

Topic	Current By-Laws	By-Laws Effective at Closing and for the Transitional Period	By-Laws Effective at the Expiration of the Transitional Period
		Governor Committee, the NASD Group Committee and the NYSE Group Committee) also has (i) a percentage of members (to the nearest whole number of committee members) that are members of the NASD Group Committee at least as great as the percentage of Governors on the Board that are members of the NASD Group Committee; and (ii) a percentage of members (to the nearest whole number of committee members) that are members of the NYSE Group Committee at least as great as the percentage of Governors on the Board that are members of the NYSE Group Committee.	
Executive Committee Composition	The Executive Committee consists of no fewer than five and no more than eight Governors. The Executive Committee includes the Chief Executive Officer of the NASD, and at least one Director of NASD Regulation. The Executive Committee has a percentage of Non-Industry committee members at least as great as the percentage of Non-Industry Governors on the whole Board and a percentage of Public committee members at least as great as the percentage of Public Governors on the whole Board.	The Executive Committee consists of no fewer than five and no more than eight Governors. The Executive Committee includes the Chief Executive Officer of the New SRO and the Chair of the Board.	Same as Transitional Period.

Topic	Current By-Laws	By-Laws Effective at Closing and for the Transitional Period	By-Laws Effective at the Expiration of the Transitional Period
Integration Committee	No such committee.	The Board shall appoint an Integration Committee with a term of one year unless continued for a longer period by resolution of the Board. The Chair of the Board shall be the Chair of the Integration Committee.	Not applicable.
Annual Meetings of Members	An annual meeting members of the NASD is held on such date and at such place as the Board designates. The business of the annual meeting includes the election of the members of the Board, Industry, Non-Industry and Public, by all of the members of the NASD.	Except for the first annual meeting following the Closing at which Large Firm Governors, the Mid-Size Firm Governor and Small Firm Governors are elected, there are no annual meetings of members during the Transitional Period. At such first annual meeting, Small Firm members are only entitled to vote for the election of Small Firm Governors, Mid-Size Firm members are only entitled to vote for the election of the Mid-Size Firm Governor and Large Firm members are only entitled to vote for the election of Large Firm Governors.	An annual meeting of members of the New SRO is held on such date and at such place as the Board designates. The business of the annual meeting includes the election of the Small, Mid-Size and Large Firm members of the Board. Small Firm members are only entitled to vote for the election of Small Firm Governors, Mid-Size Firm members are only entitled to vote for the election of the Mid-Size Firm Governor and Large Firm members are only entitled to vote for the election of Large Firm Governors.
Authority to Call Special Meetings of the Board	Not specified.	Special meetings of the Board of the New SRO may be called by the Board, the Chief Executive Officer of the New SRO, the Chair or the Lead Governor.	Same as the Transitional Period.
Authority to Include Items on the Agenda for Meetings of the Board	Not specified.	Each of the Chief Executive Officer of the New SRO and the Chair, and with respect to matters from which the Chief Executive Officer of the New SRO and the Chair recuse themselves, the Lead Governor, has the authority to include matters on the agenda of a meeting of the Board.	Same as the Transitional Period.

Topic	Current By-Laws	By-Laws Effective at Closing and for the Transitional Period	By-Laws Effective at the Expiration of the Transitional Period
Chair	Elected by the Board from among its members.	The Chair is the Chief Executive Officer of NYSE Regulation, Inc. as of Closing so long as he remains a Governor. In the event the Chief Executive Officer of NYSE Regulation, Inc. as of the Closing ceases to be a Chair during the Transitional Period, subject to the Restated Certificate of Incorporation and the By-Laws, the Chair is selected by the NYSE Group Committee from among its members; provided that the Chair so selected may not be a member of the Board of Directors of NYSE Group, Inc. nor may the successor Chief Executive Officer of NYSE Regulation, Inc. serve as Chair.	Elected by the Board from among its members.

The proposed amendments to the By-Laws also include changes or additions to defined terms. These changes or additions to the defined terms in the By-Laws include the following:

Term	Current By-Laws	By-Laws Effective at Closing and through and after the Transitional Period
Closing	Not applicable.	Means the closing of the consolidation of certain member firm regulatory functions of NYSE Regulation, Inc. and NASD.
Disqualification	As currently written, the definition lists some, but not all, of the grounds for statutory disqualification contained in Section 3(a)(39) of the Exchange Act.	Means the definition that is contained in Section 3(a)(39) of the Exchange Act. The purpose of the amendment is to conform the By-Laws directly to the statutory provision that NASD is obligated to enforce, as well as to conform the By-Laws to any subsequent amendments to the statute.
Floor Member Governor	Not applicable.	Means a member of the Board appointed as such who is a person associated with a member (or a firm in the process of becoming a member) which is a specialist or floor broker on the New York Stock Exchange trading floor.

Term	Current By-Laws	By-Laws Effective at Closing and through and after the Transitional Period
Independent Dealer/ Insurance Affiliate Governor	Not applicable.	Means a member of the Board appointed as such who is a person associated with a member which is an independent contractor financial planning member firm or an insurance company, or an affiliate of such a member.
Industry Governor or Industry committee member	Means a Governor (excluding the Chief Executive Officer of the NASD and the President of NASD Regulation) or committee member who: (1) is or has served in the prior three years as an officer, director or employee of a broker or dealer, excluding an outside director or a director not engaged in the day-to-day management of a broker or dealer; (2) is an officer, director (excluding an outside director), or employee of an entity that owns more than ten percent of the equity of a broker or dealer, and the broker or dealer accounts for more than five percent of the gross revenues received by the consolidated entity; (3) owns more than five percent of the equity securities of any broker or dealer, whose investments in brokers or dealers exceed ten percent of his or her net worth, or whose ownership interest otherwise permits him or her to be engaged in the day-to-day management of a broker or dealer; (4) provides professional services to brokers or dealers, and such services constitute 20 percent or more of the professional revenues received by the Governor or committee member or 20 percent or more of the gross revenues received by the Governor's or committee member's firm or partnership; (5) provides professional services to a director, officer, or employee of a broker, dealer, or corporation that owns 50 percent or more of the voting stock of a broker or dealer, and such services relate to the director's, officer's, or employee's professional capacity and constitute 20 percent or	Means the Floor Member Governor, the Independent Dealer/Insurance Affiliate Governor and the Investment Company Affiliate Governor and any other Governor (excluding the Chief Executive Officer of the New SRO and, during the Transitional Period, the Chief Executive Officer of NYSE Regulation, Inc.) or committee member who: (1) is or has served in the prior year as an officer, director (other than as an independent director), employee or controlling person of a broker or dealer, or (2) has a consulting or employment relationship with or provides professional services to a self-regulatory organization registered under the Exchange Act, or has had any such relationship or provided any such services at any time within the prior year.

Term	Current By-Laws	By-Laws Effective at Closing and through and after the Transitional Period
	more of the professional revenues received by the Governor or committee member or 20 percent or more of the gross revenues received by the Governor's or committee member's firm or partnership; or (6) has a consulting or employment relationship with or provides professional services to the NASD, NASD Regulation, NASD Dispute Resolution, or a market for which NASD provides regulation, or has had any such relationship or provided any such services at any time within the prior three years.	
Investment Company Affiliate Governor	Not applicable.	Means a member of the Board appointed as such who is a person associated with a member which is an investment company (as defined in The Investment Company Act of 1940, as amended) or an affiliate of such a member.
Joint Public Governor	Not applicable.	Means the one Public Governor to be appointed as such by the Board of Directors of NYSE Group, Inc. and the Board in office prior to the Closing jointly.
Large, Mid-Size and Small Firms	Not applicable.	Mean any broker or dealer admitted to membership in the New SRO which, at the time of determination, has 1-150, 151-499 or 500 or more registered persons, respectively.
Large Firm, Mid-Size Firm and Small Firm Governors	Not applicable.	Mean members of the Board to be elected by Large, Mid-Size and Small Firm members, respectively, provided, however, that in order to be eligible to serve, a Large Firm, Mid-Size Firm and Small Firm Governor must be an Industry Governor and must be registered with a member which is a Large Firm, Mid-Size Firm or Small Firm member, as the case may be.
Large Firm Governor and Small Firm Governor Committees	Not applicable.	Means a committee of the Board comprised of all of the Large Firm Governors or Small Firm Governors, as the case may be.

Term	Current By-Laws	By-Laws Effective at Closing and through and after the Transitional Period
Lead Governor	Not applicable.	Means a member of the Board elected as such by the Board, provided, however, that any member of the Board who is concurrently serving as a member of the Board of Directors of NYSE Group, Inc. is not eligible to serve as the Lead Governor.
NASD Public Governors and NYSE Public Governors	Not applicable.	Mean the five Public Governors to be appointed as such by the Board in office prior to the Closing and the five Public Governors to be appointed as such by the Board of Directors of NYSE Group, Inc., respectively, effective as of Closing.
NASD Group Committee	Not applicable.	Means a committee of the Board comprised of the five Public Governors and the Independent Dealer/Insurance Affiliate Governor appointed as such by the Board in office prior to Closing, and the Small Firm Governors which were nominated for election as such by the Board in office prior to Closing, and in each case their successors.
NYSE Group Committee	Not applicable.	Means a committee of the Board comprised of the five Public Governors and the Floor Member Governor appointed as such by the Board of Directors of NYSE Group, Inc., and the Large Firm Governors which were nominated for election as such by the Board of Directors of NYSE Group, Inc., and in each case their successors.
Non-Industry Governor or Non-Industry committee member	Means a Governor (excluding the Chief Executive Officer and any other officer of the NASD, the President of NASD Regulation) or committee member who is: (1) a Public Governor or committee member; (2) an officer or employee of an issuer of securities listed on a market for which NASD provides regulation; (3) an	Not applicable.

Term	Current By-Laws	By-Laws Effective at Closing and through and after the Transitional Period
	officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market; or (4) any other individual who would not be an Industry Governor or committee member.	
Public Governor or Public committee member	Means a Governor or committee member who has no material business relationship with a broker or dealer or the NASD, NASD Regulation, NASD Dispute Resolution, or a market for which NASD provides regulation.	Means any Governor or committee member who is not the Chief Executive Officer of the New SRO or, during the Transitional Period, the Chief Executive Officer of NYSE Regulation, Inc., who is not an Industry Governor and who otherwise has no material business relationship with a broker or dealer or a self-regulatory organization registered under the Exchange Act, other than as a public director of such a self-regulatory organization.
Transitional Period	Not applicable.	Means the period commencing on the date of the Closing and ending on the third anniversary of the date of the Closing.

Recommendation of the NASD Board

The NASD Board recommends that NASD members vote **"FOR"** approval of the amendments to the By-Laws.

Appendix A

Provisions of NASD By-Laws Relevant to NYSE Transaction

ARTICLE I

DEFINITIONS

When used in these By-Laws, unless the context otherwise requires, the term:

(a) "Act" means the Securities Exchange Act of 1934, as amended;

(b) "bank" means (1) a banking institution organized under the laws of the United States, (2) a member bank of the Federal Reserve System, (3) any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency pursuant to the first section of Public Law 87-722 (12 U.S.C. § 92a), and which is supervised and examined by a State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of the Act, and (4) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (1), (2), or (3) of this subsection;

(c) "Board" means the Board of Governors of the ~~NASD~~Corporation;

(d) "branch office" means an office defined as a branch office in the Rules of the ~~Association~~Corporation;

(e) "broker" means any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization, or other legal entity engaged in the business of effecting transactions in securities for the account of others, but does not include a bank;

(f) "Closing" means the closing of the consolidation of certain member firm regulatory functions of NYSE Regulation, Inc. and the Corporation;

(g)~~(f)~~ "Commission" means the Securities and Exchange Commission;

(h) "controlling" shall mean the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting stock, by contract or otherwise. A person who is the owner of 20% or more of the outstanding voting stock of any corporation, partnership, unincorporated association or other entity shall be presumed to have control of such entity, in the absence of proof by a preponderance of the evidence to the contrary. Notwithstanding the foregoing, a presumption of control shall not apply where such person holds voting stock, in good faith, as an agent, bank, broker, nominee, custodian or trustee for one or more owners who do not individually or as a group have control of such entity;

(i) "Corporation" means the National Association of Securities Dealers, Inc. or any future name of this entity;

(j)~~(g)~~ "day" means calendar day;

(k)~~(h)~~ "dealer" means any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization, or other legal entity engaged in the business of buying and selling securities for such individual's or entity's own account, through

a broker or otherwise, but does not include a bank, or any person insofar as such person buys or sells securities for such person's own account, either individually or in some fiduciary capacity, but not as part of a regular business;

(l)~~(i)~~ "Delegation Plan" means the "Plan of Allocation and Delegation of Functions by NASD to Subsidiaries" as approved by the Commission, and as amended from time to time;

(m)~~(j)~~ "district" means a district established by the NASD Regulation Board pursuant to the NASD Regulation By-Laws;

(n) "Floor Member Governor" means a member of the Board appointed as such who is a person associated with a member (or a firm in the process of becoming a member) which is a specialist or floor broker on the New York Stock Exchange trading floor;

(o)~~(k)~~ "government securities broker" shall have the same meaning as in Section 3(a)(43) of the Act except that it shall not include financial institutions as defined in Section 3(a)(46) of the Act;

(p)~~(l)~~ "government securities dealer" shall have the same meaning as in Section 3(a)(44) of the Act except that it shall not include financial institutions as defined in Section 3(a)(46) of the Act;

(q)~~(m)~~ "Governor" means a member of the Board;

(r) "Independent Dealer/Insurance Affiliate Governor" means a member of the Board appointed as such who is a person associated with a member which is an independent contractor financial planning member firm or an insurance company, or an affiliate of such a member;

(s)~~(n)~~ "Industry Director" means a Director of the NASD Regulation Board or NASD Dispute Resolution Board (excluding the Presidents) who: (1) is or has served in the prior ~~three years~~year as an officer, director (other than as an independent director), ~~or~~ employee or controlling person of a broker or dealer, ~~excluding an outside director or a director not engaged in the day-to-day management of a broker or dealer; (2) is an officer, director (excluding an outside director), or employee of an entity that owns more than ten percent of the equity of a broker or dealer, and the broker or dealer accounts for more than five percent of the gross revenues received by the consolidated entity; (3) owns more than five percent of the equity securities of any broker or dealer, whose investments in brokers or dealers exceed ten percent of his or her net worth, or whose ownership interest otherwise permits him or her to be engaged in the day-to-day management of a broker or dealer; (4) provides professional services to brokers or dealers, and such services constitute 20 percent or more of the professional revenues received by the Director or 20 percent or more of the gross revenues received by the Director's firm or partnership; (5) provides professional services to a director, officer, or employee of a broker, dealer, or corporation that owns 50 percent or more of the voting stock of a broker or dealer, and such services relate to the director's, officer's, or employee's professional capacity and constitute 20 percent or more of the professional revenues received by the Director or 20 percent or more of the gross revenues received by the Director's firm or partnership; or (6~~or (2) has a consulting or employment relationship with or provides professional services to ~~the NASD, NASD Regulation, NASD Dispute Resolution, or a market for which NASD provides regulation~~a self regulatory organization registered under the Act, or has had any such relationship or provided any such services at any time within the prior ~~three years~~year;

(t)~~(o)~~ "Industry Governor" or "Industry committee member" means ~~a~~the Floor Member Governor, the Independent Dealer/Insurance Affiliate Governor and the Investment Company

Affiliate Governor and any other Governor (excluding the Chief Executive Officer of the ~~NASD and the President of NASD~~Corporation and, during the Transitional Period, the Chief Executive Officer of NYSE Regulation, Inc.) or committee member who: (1) is or has served in the prior ~~three years~~year as an officer, director ~~or~~(other than as an independent director), employee or controlling person of a broker or dealer, ~~excluding an outside director or a director not engaged in the day-to-day management of a broker or dealer; (2) is an officer, director (excluding an outside director), or employee of an entity that owns more than ten percent of the equity of a broker or dealer, and the broker or dealer accounts for more than five percent of the gross revenues received by the consolidated entity; (3) owns more than five percent of the equity securities of any broker or dealer, whose investments in brokers or dealers exceed ten percent of his or her net worth, or whose ownership interest otherwise permits him or her to be engaged in the day-to-day management of a broker or dealer; (4) provides professional services to brokers or dealers, and such services constitute 20 percent or more of the professional revenues received by the Governor or committee member or 20 percent or more of the gross revenues received by the Governor's or committee member's firm or partnership; (5) provides professional services to a director, officer, or employee of a broker, dealer, or corporation that owns 50 percent or more of the voting stock of a broker or dealer, and such services relate to the director's, officer's, or employee's professional capacity and constitute 20 percent or more of the professional revenues received by the Governor or committee member or 20 percent or more of the gross revenues received by the Governor's or committee member's firm or partnership; or (6~~or (2) has a consulting or employment relationship with or provides professional services to ~~the NASD, NASD Regulation, NASD Dispute Resolution, or a market for which NASD provides regulation~~a self regulatory organization registered under the Act, or has had any such relationship or provided any such services at any time within the prior ~~three years~~year;

(u)~~(p)~~ "investment banking or securities business" means the business, carried on by a broker, dealer, or municipal securities dealer (other than a bank or department or division of a bank), or government securities broker or dealer, of underwriting or distributing issues of securities, or of purchasing securities and offering the same for sale as a dealer, or of purchasing and selling securities upon the order and for the account of others;

(v) "Investment Company" means an "investment company" as such term is defined in The Investment Company Act of 1940, as amended;

(w) "Investment Company Affiliate Governor" means a member of the Board appointed as such who is a person associated with a member which is an Investment Company or an affiliate of such a member;

(x) "Joint Public Governor" means the one Public Governor to be appointed as such by the Board of Directors of NYSE Group, Inc. and the Board in office prior to the Closing jointly;

(y) "Large Firm" means any broker or dealer admitted to membership in the Corporation which, at the time of determination, has 500 or more registered persons;

(z) "Large Firm Governor" means a member of the Board to be elected by Large Firm members, provided, however, that in order to be eligible to serve, a Large Firm Governor must be an Industry Governor and must be registered with a member which is a Large Firm member;

(aa) "Large Firm Governor Committee" means a committee of the Board comprised of all of the Large Firm Governors;

(bb) "Lead Governor" means a member of the Board elected as such by the Board, provided, however, that any member of the Board who is concurrently serving as a member of the Board of Directors of NYSE Group, Inc. shall not be eligible to serve as the Lead Governor;

(cc) "Mid-Size Firm" means any broker or dealer admitted to membership in the Corporation which, at the time of determination, has at least 151 and no more than 499 registered persons;

(dd) "Mid-Size Firm Governor" means a member of the Board to be elected by Mid-Size Firm members, provided, however, that in order to be eligible to serve, a Mid-Size Firm Governor must be an Industry Governor and must be registered with a member which is a Mid-Size Firm member;

(ee)~~(q)~~ "member" means any broker or dealer admitted to membership in the ~~NASD~~ Corporation;

(ff)~~(r)~~ "municipal securities" means securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond as defined by Section 3(a)(29) of the Act;

(gg)~~(s)~~ "municipal securities broker" means a broker, except a bank or department or division of a bank, engaged in the business of effecting transactions in municipal securities for the account of others;

(hh)~~(t)~~ "municipal securities dealer" means any person, except a bank or department or division of a bank, engaged in the business of buying and selling municipal securities for such person's own account, through a broker or otherwise, but does not include any person insofar as such person buys or sells securities for such person's own account either individually or in some fiduciary capacity, but not as a part of a regular business;

~~(u) "NASD" means the National Association of Securities Dealers, Inc.;~~

(ii)~~(v)~~ "NASD Dispute Resolution" means NASD Dispute Resolution, Inc. or any future name of this entity;

~~(w) "Nasdaq" means The Nasdaq Stock Market, Inc.;~~

(jj) "NASD Group Committee" means a committee of the Board comprised of the five Public Governors and the Independent Dealer/Insurance Affiliate Governor appointed as such by the Board in office prior to Closing, and the Small Firm Governors which were nominated for election as such by the Board in office prior to Closing, and in each case their successors;

(kk) "NASD Public Governors" means the five Public Governors to be appointed as such by the Board in office prior to the Closing effective as of Closing;

(ll)~~(x)~~ "NASD Regulation" means NASD Regulation, Inc. or any future name of this entity;

(mm)~~(y)~~ "NASD Regulation Board" means the Board of Directors of NASD Regulation;

(nn)~~(z)~~ "National Adjudicatory Council" means a body appointed pursuant to Article V of the NASD Regulation By-Laws;

(oo)~~(aa) "National~~ "Nominating Committee" means the ~~National~~ Nominating Committee appointed pursuant to Article VII, Section 9 of these By-Laws;

~~(bb) "Non-Industry Director" means a Director of the NASD Regulation Board or NASD Dispute Resolution Board (excluding the Presidents of NASD Regulation and NASD Dispute Resolution) who is: (1) a Public Director; (2) an officer or employee of an issuer of securities listed on a market for which NASD provides regulation; (3) an officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market; or (4) any other individual who would not be an Industry Director;~~

~~(cc) "Non-Industry Governor" or "Non-Industry committee member" means a Governor (excluding the Chief Executive Officer and any other officer of the NASD, the President of NASD Regulation) or committee member who is: (1) a Public Governor or committee member; (2) an officer or employee of an issuer of securities listed on a market for which NASD provides regulation; (3) an officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market; or (4) any other individual who would not be an Industry Governor or committee member;~~

(pp) "NYSE Group Committee" means a committee of the Board comprised of the five Public Governors and the Floor Member Governor appointed as such by the Board of Directors of NYSE Group, Inc., and the Large Firm Governors which were nominated for election as such by the Board of Directors of NYSE Group, Inc., and in each case their successors;

(qq) "NYSE Public Governors" shall mean the five Public Governors to be appointed as such by the Board of Directors of NYSE Group, Inc. effective as of Closing;

(rr)~~(dd)~~ "person associated with a member" or "associated person of a member" means: (1) a natural person who is registered or has applied for registration under the Rules of the ~~Association~~Corporation; (2) a sole proprietor, partner, officer, director, or branch manager of a member, or other natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with the ~~NASD~~Corporation under these By-Laws or the Rules of the ~~Association~~Corporation; and (3) for purposes of Rule 8210, any other person listed in Schedule A of Form BD of a member;

(ss)~~(ee)~~ "Public Director" means a Director of the NASD Regulation Board or NASD Dispute Resolution Board who is not an Industry Director and who otherwise has no material business relationship with a broker or dealer or ~~the NASD, NASD Regulation, NASD Dispute Resolution, or a market for which NASD provides regulation~~a self regulatory organization registered under the Act (other than serving as a public director of such a self regulatory organization);

(tt)~~(ff)~~ "Public Governor" or "Public committee member" means aany Governor or committee member who is not the Chief Executive Officer of the Corporation or, during the Transitional Period, the Chief Executive Officer of NYSE Regulation, Inc., who is not an Industry Governor and who otherwise has no material business relationship with a broker or dealer or ~~the NASD, NASD Regulation, NASD Dispute Resolution, or a market for which NASD provides regulation;~~ a self regulatory organization registered under the Act (other than serving as a public director of such a self regulatory organization);

(uu)~~(gg)~~ "registered broker, dealer, municipal securities broker or dealer, or government securities broker or dealer" means any broker, dealer, municipal securities broker or dealer, or government securities broker or dealer which is registered with the Commission under the Act; ~~and~~

(vv)~~(hh)~~ "Rules of the ~~Association~~Corporation" or "Rules" means the numbered rules set forth in the ~~NASD Manual~~manual of the Corporation beginning with the Rule 0100 Series, as adopted by the Board pursuant to these By-Laws, as hereafter amended or supplemented;

(ww) "Small Firm" means any broker or dealer admitted to membership in the Corporation which, at the time of determination, has at least 1 and no more than 150 registered persons;

(xx) "Small Firm Governor" means a member of the Board to be elected by Small Firm members, provided, however, that in order to be eligible to serve, a Small Firm Governor must be registered with a member which is a Small Firm member and must be an Industry Governor;

(yy) "Small Firm Governor Committee" means a committee of the Board comprised of all the Small Firm Governors; and

(zz) "Transitional Period" means the period commencing on the date of the Closing and ending on the third anniversary of the date of the Closing.

ARTICLE III

QUALIFICATIONS OF MEMBERS AND ASSOCIATED PERSONS

Definition of Disqualification

Sec. 4. A person is subject to a "disqualification" with respect to membership, or association with a member, if such person~~:~~ is subject to any "statutory disqualification" as such term is defined in Section 3(a)(39) of the Act.

~~(a) has been and is expelled or suspended from membership or participation in, or barred or suspended from being associated with a member of, any self-regulatory organization, foreign equivalent of a self-regulatory organization, foreign or international securities exchange, contract market designated pursuant to Section 5 of the Commodity Exchange Act, or foreign equivalent of a contract market designated pursuant to any substantially equivalent foreign statute or regulation, or futures association registered under Section 17 of the Commodity Exchange Act or a foreign equivalent of a futures association designated pursuant to any substantially equivalent foreign statute or regulation, or has been and is denied trading privileges on any such contract market or foreign equivalent;~~

~~(b) is subject to~~

~~(1) an order of the Commission, other appropriate regulatory agency, or foreign financial regulatory authority:~~

~~(i) denying, suspending for a period not exceeding 12 months, or revoking such person's registration as a broker, dealer, municipal securities dealer, government securities broker, or government securities dealer, or limiting such person's activities as a foreign person performing a function substantially equivalent to any of the above; or~~

~~(ii) barring or suspending for a period not exceeding 12 months such person from being associated with a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, or foreign person performing a function substantially equivalent to any of the above;~~

(2) an order of the Commodity Futures Trading Commission denying, suspending, or revoking such person's registration under the Commodity Exchange Act (7 U.S.C. § 1 et seq.); or

(3) an order by a foreign financial regulatory authority denying, suspending, or revoking the person's authority to engage in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof;

(c) by such person's conduct while associated with a broker, dealer, municipal securities dealer, government securities broker, or government securities dealer, or while associated with an entity or person required to be registered under the Commodity Exchange Act, has been found to be a cause of any effective suspension, expulsion, or order of the character described in subsection (a) or (b) of this Section;

(d) by such person's conduct while associated with any broker, dealer, municipal securities dealer, government securities broker, government securities dealer, or any other entity engaged in transactions in securities, or while associated with an entity engaged in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof, has been found to be a cause of any effective suspension, expulsion, or order by a foreign or international securities exchange or foreign financial regulatory authority empowered by a foreign government to administer or enforce its laws relating to financial transactions as described in subsection (a) or (b) of this Section;

(e) has associated with him or her any person who is known, or in the exercise of reasonable care should be known, to him or her to be a person described in subsection (a), (b), (c), or (d) of this Section;

(f) has willfully made or caused to be made in any application for membership in a self-regulatory organization, or to become associated with a member of a self-regulatory organization, or in any report required to be filed with a self-regulatory organization, or in any proceeding before a self-regulatory organization, any statement which was at the time, and in light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application, report, or proceeding any material fact which is required to be stated therein;

(g)

(1) has been convicted within ten years preceding the filing of any application for membership in the NASD, or to become associated with a member of the NASD, or at any time thereafter, of any felony or misdemeanor or of a substantially equivalent crime by a foreign court of competent jurisdiction which:

(i) involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, any substantially equivalent activity however denominated by the laws of the relevant foreign government, or conspiracy to commit any such offense;

(ii) arises out of the conduct of the business of a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, investment adviser, bank, insurance company, fiduciary, transfer agent,

~~foreign person performing a function substantially equivalent to any of the above, or any entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent foreign statute or regulation;~~

~~(iii) involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities, or substantially equivalent activity however denominated by the laws of the relevant foreign government; or~~

~~*(iv) involves* the violation of Sections 152, 1341, 1342, or 1343 *or* Chapters 25 or 47 of Title 18, United States Code, or a violation of a substantially equivalent foreign statute;~~

~~(2) has been convicted within ten years preceding the filing of any application for membership in the NASD, or to become associated with a member of the NASD, or at any time thereafter of any other felony;~~

~~(h) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities broker, government securities dealer, transfer agent, foreign person performing a function substantially equivalent to any of the above, entity or person required to be registered under the Commodity Exchange Act, or any substantially equivalent foreign statute or regulation, or as an affiliated person or employee of any investment company, bank, insurance company, foreign entity substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent foreign statute or regulation, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security;~~

~~(i) has been found by a foreign financial regulatory authority to have—~~

~~(1) made or caused to be made in any application for registration or report required to be filed with a foreign financial regulatory authority, or in any proceeding before a foreign financial regulatory authority with respect to registration, any statement that was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any application or report to the foreign financial regulatory authority any material fact that is required to be stated therein;~~

~~(2) violated any foreign statute or regulation regarding transactions in securities, or contracts of sale of a commodity for future delivery, traded on or subject to the rules of a contract market or any board of trade; or~~

~~(3) aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of any statutory provisions enacted by a foreign government, or rules or regulations thereunder, empowering a foreign financial regulatory authority regarding transactions in securities, or contracts of sale of a commodity for future delivery, traded or subject to the rules of a contract market or any board of trade, or has been found, by a foreign financial regulatory authority, to have failed reasonably to supervise, with a view to preventing violations of such statutory provisions, rules, and regulations, another person who commits such a violation, if such other person is subject to such person's supervision.~~

ARTICLE IV

MEMBERSHIP

Application for Membership

Sec. 1. (a) Application for membership in the ~~NASD~~Corporation, properly signed by the applicant, shall be made to the ~~NASD~~Corporation via electronic process or such other process as the ~~NASD~~Corporation may prescribe, on the form to be prescribed by the ~~NASD~~Corporation, and shall contain:

(1) an agreement to comply with the federal securities laws, the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board and the Treasury Department, the By-Laws of the ~~NASD~~Corporation, NASD Regulation, ~~Nasdaq,~~ or NASD Dispute Resolution, the Rules of the ~~Association~~Corporation, and all rulings, orders, directions, and decisions issued and sanctions imposed under the Rules of the ~~Association~~Corporation;

(2) an agreement to pay such dues, assessments, and other charges in the manner and amount as from time to time shall be fixed pursuant to the ~~NASD~~ By-Laws of the Corporation, Schedules to the ~~NASD~~ By-Laws of the Corporation, and the Rules of the ~~Association~~Corporation; and

(3) such other reasonable information with respect to the applicant as the ~~NASD~~Corporation may require.

(b) Any application for membership received by the ~~NASD~~Corporation shall be processed in the manner set forth in the Rules of the ~~Association~~Corporation.

(c) Each applicant and member shall ensure that its membership application with the ~~NASD~~Corporation is kept current at all times by supplementary amendments via electronic process or such other process as the ~~NASD~~Corporation may prescribe to the original application. Such amendments to the application shall be filed with the ~~NASD~~Corporation not later than 30 days after learning of the facts or circumstances giving rise to the amendment.

ARTICLE V

REGISTERED REPRESENTATIVES AND ASSOCIATED PERSONS

Application for Registration

Sec. 2. (a) Application by any person for registration with the ~~NASD~~Corporation, properly signed by the applicant, shall be made to the ~~NASD~~Corporation via electronic process or such other process as the ~~NASD~~Corporation may prescribe, on the form to be prescribed by the ~~NASD~~Corporation and shall contain:

(1) an agreement to comply with the federal securities laws, the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board and the Treasury Department, the By-Laws of the ~~NASD~~Corporation, NASD Regulation, ~~Nasdaq,~~ and NASD Dispute Resolution, the Rules of the ~~Association~~Corporation, and all rulings, orders, directions, and decisions issued and sanctions imposed under the Rules of the ~~Association~~Corporation; and

(2) such other reasonable information with respect to the applicant as the ~~NASD~~Corporation may require.

(b) The ~~NASD~~Corporation shall not approve an application for registration of any person who is not eligible to be an associated person of a member under the provisions of Article III, Section 3.

(c) Every application for registration filed with the ~~NASD~~Corporation shall be kept current at all times by supplementary amendments via electronic process or such other process as the ~~NASD~~Corporation may prescribe to the original application. Such amendment to the application shall be filed with the ~~NASD~~Corporation not later than 30 days after learning of the facts or circumstances giving rise to the amendment. If such amendment involves a statutory disqualification as defined in Section 3(a)(39) and Section 15(b)(4) of the Act, such amendment shall be filed not later than ten days after such disqualification occurs.

ARTICLE VI

DUES, ASSESSMENTS, AND OTHER CHARGES

Power of the ~~NASD~~Corporation to Fix and Levy Assessments

Sec. 1. The ~~NASD~~Corporation shall prepare an estimate of the funds necessary to defray reasonable expenses of administration in carrying on the work of the ~~NASD~~Corporation each fiscal year, and on the basis of such estimate, shall fix and levy the amount of admission fees, dues, assessments, and other charges to be paid by the members ~~of the NASD~~ and issuers and any other persons using any facility or system which the ~~NASD~~Corporation, NASD Regulation, ~~Nasdaq,~~ or NASD Dispute Resolution operates or controls. Fees, dues, assessments, and other charges shall be called and payable as determined by the ~~NASD~~Corporation from time to time; provided, however, that such admission fees, dues, assessments, and other charges shall be equitably allocated among members and issuers and any other persons using any facility or system which the ~~NASD~~Corporation operates or controls. The ~~NASD~~Corporation may from time to time make such changes or adjustments in such fees, dues, assessments, and other charges as it deems necessary or appropriate to assure equitable allocation of dues among members. In the event of termination of membership or the extension of any membership to a successor organization during any fiscal year for which an assessment has been levied and become payable, the ~~NASD~~Corporation may make such adjustment in the fees, dues, assessments, or other charges payable by any such member or successor organization or organizations during such fiscal years as it deems fair and appropriate in the circumstances.

ARTICLE VII

BOARD OF GOVERNORS

Powers and Authority of Board

Sec. 1.

(a) The Board shall be the governing body of the ~~NASD~~Corporation and, except as otherwise provided by applicable law, the Restated Certificate of Incorporation, or these By-Laws, shall be vested with all powers necessary for the management and administration of the affairs of

the ~~NASD~~Corporation and the promotion of the ~~NASD~~Corporation's welfare, objects, and purposes. In the exercise of such powers, the Board shall have the authority to:

(i) adopt for submission to the membership, as hereinafter provided, such By-Laws and changes or additions thereto as it deems necessary or appropriate;

(ii) adopt such other Rules of the ~~Association~~Corporation and changes or additions thereto as it deems necessary or appropriate, provided, however, that the Board may at its option submit to the membership any such adoption, change, or addition to such Rules;

(iii) make such regulations, issue such orders, resolutions, exemptions, interpretations, including interpretations of these By-Laws and the Rules of the ~~Association~~Corporation, and directions, and make such decisions as it deems necessary or appropriate;

(iv) prescribe rules for the required or voluntary arbitration of controversies between members and between members and customers or others as it shall deem necessary or appropriate;

(v) establish rules and procedures to be followed by members in connection with the distribution of securities issued by members and affiliates thereof;

(vi) require all over-the-counter transactions in securities between members, other than transactions in exempted securities as defined in Section 3(a)(12) of the Act, to be cleared and settled through the facilities of a clearing agency registered with the Commission pursuant to the Act, which clears and settles such over-the-counter transactions in securities;

(vii) organize and operate automated systems to provide qualified subscribers with securities information and automated services. The systems may be organized and operated by a division or subsidiary company of the ~~NASD~~Corporation or by one or more independent firms under contract with the ~~NASD~~Corporation as the Board may deem necessary or appropriate. The Board may adopt rules for such automated systems, establish reasonable qualifications and classifications for members and other subscribers, provide qualification standards for securities included in such systems, require members to report promptly information in connection with securities included in such systems, and establish charges to be collected from subscribers and others;

(viii) require the prompt reporting by members of such original and supplementary trade data as the Board deems appropriate. Such reporting requirements may be administered by the ~~NASD~~Corporation, a division or subsidiary thereof, or a clearing agency registered under the Act; and

(ix) engage in any activities or conduct necessary or appropriate to carry out the ~~NASD~~Corporation's purposes under its Restated Certificate of Incorporation and the federal securities laws.

(b) In the event of the refusal, failure, neglect, or inability of any Governor to discharge such Governor's duties, or for any cause affecting the best interests of the ~~NASD~~Corporation the sufficiency of which the Board shall be the sole judge, the Board shall have the power, by the affirmative vote of two-thirds of the Governors then in office, to remove such Governor and

declare such Governor's position vacant and that, subject to the Restated Certificate of Incorporation, such position shall be filled in accordance with ~~the provisions of Section 7.~~these By-Laws; provided, that during the Transitional Period, (i) a Governor that is a member of the NYSE Group Committee may only be removed by the affirmative vote of a majority of the Governors who are members of the NYSE Group Committee and (ii) a Governor that is a member of the NASD Group Committee may only be removed by the affirmative vote of a majority of the Governors who are members of the NASD Group Committee.

(c) To the fullest extent permitted by applicable law, the Restated Certificate of Incorporation, and these By-Laws, the ~~NASD~~Corporation may delegate any power of the ~~NASD~~Corporation or the Board to a committee appointed pursuant to Article IX, Section 1, the NASD Regulation Board, the ~~Nasdaq Board, the~~ NASD Dispute Resolution Board, or ~~NASD~~the Corporation's staff in a manner not inconsistent with the Delegation Plan; provided, that during the Transitional Period, no such delegation shall occur without the prior affirmative vote of two-thirds of the Governors then in office.

Authority to Cancel or Suspend for Failure to Submit Required Information

Sec. 2.

(a) The Board shall have authority, upon notice and opportunity for a hearing, to cancel or suspend the membership of any member or suspend the association of any person associated with a member for failure to file, or to submit on request, any report, document, or other information required to be filed with or requested by the ~~NASD~~Corporation pursuant to these By-Laws or the Rules of the ~~Association~~Corporation.

(b) Any membership or association suspended or canceled pursuant to this Section may be reinstated by the ~~NASD~~Corporation pursuant to the Rules of the ~~Association~~Corporation.

(c) The Board is authorized to delegate its authority under this Section in a manner not inconsistent with the Delegation Plan and otherwise in accordance with the Rules of the ~~Association~~Corporation.

Authority to Take Action Under Emergency or Extraordinary Market Conditions

Sec. 3. The Board, or such person or persons as may be designated by the Board, in the event of an emergency or extraordinary market conditions, shall have the authority to take any action regarding:

(a) the trading in or operation of the over-the-counter securities market, the operation of any automated system owned or operated by the ~~NASD,~~Corporation, or NASD Regulation~~, or Nasdaq~~, and the participation in any such system of any or all persons or the trading therein of any or all securities; and

(b) the operation of any or all member firms' offices or systems, if, in the opinion of the Board or the person or persons hereby designated, such action is necessary or appropriate for the protection of investors or the public interest or for the orderly operation of the marketplace or the system.

Composition and Qualifications of the Board

Sec. 4.

(a) The Board shall consist of no fewer than ~~15 nor more than 25 Governors, comprising (i) the Chief Executive Officer of the NASD, ii) if the Board of Governors determines, from time to time, in its sole discretion, that the appointment of a second officer of the NASD to the Board of Governors is advisable, a second officer of the NASD, (iii) the President of NASD Regulation, (iv) the Chair of the National Adjudicatory Council, and (v) no fewer than 12 and no more than 22 Governors elected by the members of the NASD. The Governors elected by the members of the NASD shall include a representative of an issuer of investment company shares or an affiliate of such an issuer, a representative of an insurance company, a representative of a national retail firm, a representative of a regional retail or independent financial planning member firm, a representative of a firm that provides clearing services to other NASD members, and a representative of an NASD member having not more than 150 registered persons. The number of Non-Industry Governors shall exceed the number of Industry Governors. If the number of Industry and Non-Industry Governors is 13–15, the Board shall include at least four Public Governors. If the number of Industry and Non-Industry Governors is 16–17, the Board shall include at least five Public Governors. If the number of Industry and Non-Industry Governors is 18–23, the Board shall include at least six Public Governors.~~ 16 nor more than 25 Governors. The number of Public Governors shall exceed the number of Industry Governors.

From and after the Transitional Period, the Board of Governors shall consist of (i) the Chief Executive Officer of the Corporation, (ii) a number of Public Governors determined by the Board, (iii) a Floor Member Governor, an Independent Dealer/Insurance Affiliate Governor and an Investment Company Affiliate Governor and (iv) three Small Firm Governors, one Mid-Size Firm Governor and three Large Firm Governors.

(b) As soon as practicable following the annual election of Governors, the Board shall elect from among its members a Chair and such other persons having such titles as it shall deem necessary or advisable, to serve until the next annual election or until their successors are chosen and qualify. The Chair of the ~~National Adjudicatory Council may not serve as Chair of the Board. The Chair and~~Board shall preside over all meetings of the Board, and shall not have any other power or authority except as otherwise expressly provided for herein. The Lead Governor shall preside at all meetings of the Board at which the Chair is not present, and shall have the authority to call, and will lead if the Chair of the Board is recused, executive sessions of the Board. Any other persons elected under this subsection shall have such powers and duties as may be determined from time to time by the Board. ~~The~~Except as otherwise provided herein, the Board, by resolution adopted by a majority of the Governors then in office, (i) after the completion of the Transitional Period, may remove ~~the Chair and any person~~ the Chair and any person elected under this subsection from such position at any time and (ii) during the Transitional Period, may remove any person, other than the Chair, elected under this subsection from such position at any time.

Term of Office of Governors

~~(a)~~(a) ~~The Chief Executive Officer and, if appointed, the second officer of the NASD, and the President of NASD Regulation~~

Sec. 5.

From and after the Transitional Period:

The Chief Executive Officer shall serve as ~~Governors~~a Governor until a successor is elected, or until death, resignation, or removal ~~(or, in addition, in the case of a second officer of the NASD, until the Board of Governors, in its sole discretion, determines that such appointment is no longer advisable).~~.

Public Governors and the Floor Member Governor, the Independent Dealer/Insurance Affiliate Governor and the Investment Company Affiliate Governor (the "Appointed Governors") shall be appointed by the Board from candidates recommended to the Board by the Nominating Committee.

As of the first annual meeting of members following the Transitional Period, the Appointed Governors shall be divided by the Board into three classes, as equal in number as possible, with the first class holding office until the first succeeding annual meeting of members, the second class holding office until the second succeeding annual meeting of members and the third class holding office until the third succeeding annual meeting of members, or until a successor is duly appointed and qualified, or until death, resignation, disqualification, or removal. Each class shall initially contain as equivalent a number as possible of Appointed Governors who were members of the NYSE Group Committee during the Transitional Period or are successors to such Governor positions, on the one hand, and Appointed Governors who were members of the NASD Group Committee during the Transitional Period or are successors to such Governor positions, on the other hand, to the extent the Board determines such persons are to remain Governors after the Transitional Period. No Appointed Governor may serve more than two consecutive terms. If a Governor is appointed to fill a vacancy of such a Governor position for a term of less than one year, the Governor may serve up to two consecutive terms following the expiration of the Governor's initial term. At each annual election following the first annual meeting of members following the Transitional Period, Appointed Governors shall be appointed by the Board for a term of three years to replace those whose terms expire.

~~(b) The Chair of the National Adjudicatory Council shall serve as a Governor for a term of one year~~As of the first annual meeting of members following the Transitional Period, the Large Firm Governors, the Mid-Size Firm Governor and the Small Firm Governors shall be divided into three classes, as equal in number as possible, with the first class, being comprised of one Large Firm Governor and one Small Firm Governor, holding office until the first succeeding annual meeting of members, the second class, being comprised of one Large Firm Governor, one Mid-Size Firm Governor and one Small Firm Governor, holding office until the second succeeding annual meeting of members and the third class, being comprised of one Large Firm Governor and one Small Firm Governor, holding office until the third succeeding annual meeting of members, or until a successor is duly elected and qualified, or until death, resignation, disqualification, or removal. ~~A Chair of the National Adjudicatory Council~~ A Governor elected by the members may not serve more than two consecutive ~~one year~~ terms ~~as a Governor, unless a Chair of the National Adjudicatory Council is appointed to fill~~. If a Governor is elected to fill a vacancy of such a Governor position for a term of less than one year ~~for such office. In such case, the Chair of the National Adjudicatory Council may serve an initial term as a Governor and~~, the Governor may serve up to two consecutive ~~one year terms as a Governor~~terms following the expiration of ~~such initial term. After serving as a Chair of the National Adjudicatory Council, an individual may serve as a Governor elected by the members of the NASD~~the Governor's initial term. At each annual election following the first annual meeting of members following the Transitional Period, Large Firm Governors, Small Firm Governors and the Mid-Size Firm Governor shall be elected for a term of three years to replace those whose terms expire.

~~(c) The Governors elected by the members of the NASD shall be divided into three classes and hold office for a term of no more than three years, such term to be fixed by the Board at the time of the nomination or certification of each such Governor, or until a successor is duly elected and qualified, or until death, resignation, disqualification, or removal. A Governor elected by the members of the NASD may not serve more than two consecutive terms. If a Governor is elected by the Board to fill a term of less than one year, the Governor may serve up to two consecutive terms following the expiration of the Governor's initial term. The term of office of Governors of the first class shall expire at the January 1999 Board meeting, of the second class one year thereafter, and of the third class two years thereafter. At each annual election, commencing January 1999, Governors shall be elected for a term of three years to replace those whose terms expire.~~

In the event of any vacancy among the Large Firm Governors, the Mid-Size Firm Governor or the Small Firm Governors, such vacancy shall only be filled by the Large Firm Governor Committee in the case of a Large Firm Governor vacancy, the Board in the case of a Mid-Size Firm Governor vacancy or the Small Firm Governor Committee in the case of a Small Firm Governor vacancy; provided, however, that in the event the remaining term of office of any Large Firm, Mid-Size Firm or Small Firm Governor position that becomes vacant is for more than 12 months, such vacancy shall be filled by the members entitled to vote thereon at a meeting thereof convened to vote thereon.

Disqualification

Sec. 6. Notwithstanding Section 5 or Article XXII, the term of office of a Governor shall terminate immediately upon a determination by the Board, by a majority vote of the remaining Governors, that: (a) the Governor no longer satisfies the classification for which the Governor was elected; and (b) the Governor's continued service as such would violate the compositional requirements of the Board set forth in Section 4 (or, in the case of the Transitional Period, Article XXII). If the term of office of a Governor terminates under this Section, and the remaining term of office of such Governor at the time of termination is not more than six months, during the period of vacancy the Board shall not be deemed to be in violation of Section 4 (or, in the case of the Transitional Period, Article XXII) by virtue of such vacancy.

~~**Filling of Vacancies**~~

~~**Sec. 7.** If an elected Governor position becomes vacant, whether because of death, disability, disqualification, removal, or resignation, the National Nominating Committee shall nominate, and the Board shall elect by majority vote of the remaining Governors then in office, a person satisfying the classification (Industry, Non-Industry, or Public Governor) for the governorship as provided in Section 4 to fill such vacancy, except that if the remaining term of office for the vacant Governor position is not more than six months, no replacement shall be required. If the remaining term of office for the vacant Governor position is more than one year, the Governor elected by the Board to fill such position shall stand for election in the next annual election pursuant to this Article.~~

Intentionally Deleted

Sec. 7. Intentionally deleted.

Meetings of Board; Quorum; Required Vote

Sec. 8. Meetings of the Board shall be held at such times and places, upon such notice, and in accordance with such procedure as the Board in its discretion may determine. Special meetings of the Board of the Corporation may be called by the Board, the Chief Executive Officer of the Corporation, the Chair or the Lead Governor. Each of the Chief Executive Officer of the Corporation and the Chair,

and with respect to matters from which the Chief Executive Officer of the Corporation and the Chair recuse themselves, the Lead Governor, shall have the authority to include matters on the agenda of a meeting of the Board. At all meetings of the Board, unless otherwise set forth in these By-Laws or required by law, a quorum for the transaction of business shall consist of a majority of the Board, including not less than 50 percent of the ~~Non-Industry~~Public Governors. Any action taken by a majority vote at any meeting at which a quorum is present, except as otherwise provided in the Restated Certificate of Incorporation or these By-Laws, shall constitute the action of the Board. Governors or members of any committee appointed by the Board under Article IX, Section 1 may participate in a meeting of the Board or a committee by means of communications facilities that ensure all persons participating in the meeting can hear and speak to one another, and participation in a meeting pursuant to this By-Law shall constitute presence in person at such meeting. No Governor shall vote by proxy at any meeting of the Board.

The ~~National~~ Nominating Committee

Sec. 9.

(a) ~~The National~~Except as otherwise provided in these By-Laws, the Nominating Committee shall nominate and, in the event of a contested election, may, as described in Section 11(b), support: ~~Industry, Non-Industry, and Public~~Large Firm, Mid-Size Firm, Small Firm, Public, Floor Member, Independent Dealer/Insurance Affiliate and Investment Company Affiliate Governors for each such vacant or new Governor position on the ~~NASD~~ Board ~~for election by the membership~~; Industry~~, Non-Industry,~~ and Public Directors for each vacant or new position on the NASD Regulation Board and the NASD Dispute Resolution Board for election by the stockholder; and Industry~~, Non-Industry,~~ and Public members for each vacant or new position on the National Adjudicatory Council for appointment by the NASD Regulation Board.

(b) ~~The National Nominating Committee shall consist of no fewer than six and no more than nine members. The number of Non-Industry committee members shall equal or exceed the number of Industry committee members. If the National Nominating Committee consists of six members, at least two shall be Public committee members. If the National Nominating Committee consists of seven or more members, at least three shall be Public committee members. No officer or employee of the Association shall serve as a member of the National Nominating Committee in any voting or non-voting capacity. No more than three of the National Nominating Committee members and no more than two of the Industry committee members shall be current members of the NASD Board.~~ Except as otherwise provided in these By-laws, after the completion of the Transitional Period the Nominating Committee shall consist of such number of members of the Board as the Board shall determine from time to time; provided, however, that the Nominating Committee shall at all times be comprised of a number of members which is a minority of the entire Board and the Chief Executive Officer shall not be a member of the Nominating Committee. The number of Public Governors on the Nominating Committee shall equal or exceed the number of Industry Governors on the Nominating Committee.

~~(c) A National Nominating Committee member may not simultaneously serve on the National Nominating Committee and the Board, unless such member is in his or her final year of service on the Board, and following that year, that member may not stand for election to the Board until such time as he or she is no longer a member of the National Nominating Committee.~~

(c)~~(d) Members of the National~~After the completion of the Transitional Period, and except as otherwise provided in these By-Laws, members of the Nominating Committee shall be appointed annually by the Board and may be removed only by majority vote of the whole Board, after appropriate notice, for refusal, failure, neglect, or inability to discharge such member's duties.

(d)~~(e)~~ The Secretary of the ~~NASD~~Corporation shall collect from each nominee for Governor such information as is reasonably necessary to serve as the basis for a determination of the nominee's classification as ~~an Industry, Non-Industry, or Public~~a Large Firm, Mid-Size Firm, Small Firm, Public, Floor Member, Independent Dealer/Insurance Affiliate and/or Investment Company Affiliate Governor, and the Secretary shall certify to the ~~National~~ Nominating Committee (or, in the case of Article XXII, the relevant body with the authority to nominate as specified therein) each nominee's classification.

(e)~~(f)~~ At all meetings of the ~~National~~ Nominating Committee, a quorum for the transaction of business shall consist of a majority of the ~~National~~ Nominating Committee~~, including not less than 50 percent of the Non-Industry committee members~~. In the absence of a quorum, a majority of the committee members present may adjourn the meeting until a quorum is present.

Procedure for Nomination of Governors

Sec. 10. Prior to a meeting of members pursuant to Article XXI for the election of Governors, the ~~NASD~~Corporation shall notify the members of the names of each nominee selected by the ~~National~~ Nominating Committee (or, in the case of Article XXII, the relevant body with the authority to nominate as specified therein) for each governorship up for election by the members, the classification of governorship (~~Industry, Non-Industry, or Public Governor~~Large Firm, Mid-Size Firm or Small Firm) for which the nominee is nominated, the qualifications of each nominee, and such other information regarding each nominee as the ~~National~~Board or the Nominating Committee (or, in the case of Article XXII, the relevant body with the authority to nominate as specified therein) deems pertinent. A person who has not been so nominated may be included on the ballot for the election of Governors if: (a) within 45 days after the date of such notice, such person presents to the Secretary of the ~~NASD~~Corporation (i) in the case of petitions solely in support of such person, petitions in support of his or her nomination duly executed by three percent of the members entitled to vote for such nominee's election, and no such member shall endorse more than one such nominee, or (ii) in the case of petitions in support of more than one person, petitions in support of the nominations of such persons duly executed by ten percent of the members entitled to vote for such nominees' election; and (b) the Secretary certifies that (i) the petitions are duly executed by the Executive Representatives of the requisite number of members entitled to vote for such nominee's/nominees' election, and (ii) the person(s) satisfies/satisfy the classification ~~(Industry, Non-Industry, or Public~~(s) (Large Firm, Mid-Size Firm or Small Firm Governor) of the governorship(s) to be filled, based on such information provided by the person(s) as is reasonably necessary to make the certification. The Secretary shall not unreasonably withhold or delay the certification. Upon certification, the election shall be deemed a contested election with respect to the category of Governor to which the nomination relates. After the certification of a contested election or the expiration of time for contesting an election under this Section, the Secretary shall deliver notice of a meeting of members pursuant to Article XXI, Section 3(a).

Communication of Views

Sec. 11.

(a) The ~~NASD~~Corporation, the Board, a committee appointed pursuant to Article IX, Section 1, and ~~NASD~~the Corporation's staff shall not take any position publicly or with a member or person associated with or employed by a member with respect to any candidate in a contested election or nomination held pursuant to these By-Laws or the NASD Regulation By-Laws. A Governor or a member of any committee (other than the ~~National~~ Nominating Committee (or, in the case of Article XXII, the relevant body with the authority to nominate as specified

therein)) may communicate his or her views with respect to any candidate if such Governor or committee member acts solely in his or her individual capacity and disclaims any intention to communicate in any official capacity on behalf of the ~~NASD~~Corporation, the ~~NASD~~ Board, or any committee (other than the ~~National~~ Nominating Committee (or, in the case of Article XXII, the relevant body with the authority to nominate as specified therein)). Except as provided herein, any candidate and his or her representatives may communicate support for the candidate to a member or person associated with or employed by a member.

(b) In a contested election, the ~~National~~ Nominating Committee (or, in the case of Article XXII, the relevant body with the authority to nominate as specified therein) may support its nominees under this Article by sending to ~~NASD~~ members eligible to vote up to two mailings of materials in support of its nominees in lieu of mailings sent by its candidates under Article VII, Section 12. In addition to such mailings, in the event of mailings and or other communications to ~~the NASD~~ members by or on behalf of a candidate by petition in a contested election, the ~~National~~ Nominating Committee (or, in the case of Article XXII, the relevant body with the authority to nominate as specified therein) may respond in-kind, but shall not take a position unresponsive, to the contesting candidate's communications.

Administrative Support

Sec. 12. The Secretary of the ~~NASD~~Corporation shall provide administrative support to the candidates in a contested election under this Article by sending to ~~NASD~~ members eligible to vote for such category of Governors up to two mailings of materials prepared by the candidates. The ~~NASD~~Corporation shall pay the postage for the mailings. If a candidate wants such mailings sent, the candidate shall prepare such material on the candidate's personal stationery. The material shall state that it represents the opinions of the candidate. The candidate shall provide a copy of such material for each member ~~of the NASD~~eligible to vote for such category of Governors. A candidate nominated by the ~~National~~ Nominating Committee (or, in the case of XXII, the relevant body with the authority to nominate as specified therein) may identify himself or herself as such in his or her materials. Any candidate may send additional materials to ~~NASD~~ members at the candidate's own expense. Except as provided in this Article, the ~~NASD~~Corporation, the Board, any committee, and ~~NASD~~the Corporation's staff shall not provide any other administrative support to a candidate in a contested election conducted under this Article or a contested election or nomination conducted under the NASD Regulation By-Laws.

Election of Governors

Sec. 13. Governors that are to be elected by the members shall be elected by a plurality of the votes of the members of the ~~NASD~~Corporation present in person or represented by proxy at the annual meeting of the ~~NASD~~Corporation and entitled to vote ~~thereat~~for such category of Governors. The annual meeting of the ~~NASD~~Corporation shall be on such date and at such place as the Board shall designate pursuant to Article XXI. ~~Any~~Except as otherwise provided in these By-Laws or the Restated Certificate of Incorporation, any Governor so elected must be nominated by ~~the National~~ Nominating Committee or certified by the Secretary pursuant to Section 10.

Maintenance of Compositional Requirements of the Board

Sec. 14. Each elected or appointed Governor shall update the information submitted under Section 9(ed) regarding his or her classification as ~~an Industry, Non-Industry, or Public~~a Large Firm, Mid-Size Firm, Small Firm, Public, Floor Member, Independent Dealer/Insurance Affiliate and/or Investment Company Affiliate Governor at least annually and upon request of the Secretary of the ~~NASD~~Corporation, and shall report immediately to the Secretary any change in such classification.

Resignation

Sec. 15. Any Governor may resign at any time either upon written notice of resignation to the ~~Chair of the Board, the~~ Chief Executive Officer~~,~~ or the Secretary. Any such resignation shall take effect at the time specified therein or, if the time is not specified, upon receipt thereof, and the acceptance of such resignation, unless required by the terms thereof, shall not be necessary to make such resignation effective.

ARTICLE VIII

OFFICERS, AGENTS, AND EMPLOYEES

Officers

Sec. 1. The Board shall elect a Chief Executive Officer, who shall be responsible for the management and administration of its affairs and shall be the official representative of the ~~NASD~~Corporation in all public matters and who shall have such powers and duties in the management of the ~~NASD~~Corporation as may be prescribed in a resolution by the Board, and which powers and duties shall not be inconsistent with the Delegation Plan. The Board shall elect a Chief Operating Officer and Secretary, who shall have such powers and duties conferred by these By-Laws and such other powers and duties as may be prescribed in a resolution by the Board. The Board may provide for such other executive or administrative officers as it shall deem necessary or advisable~~, including, but not limited to, Executive Vice President, Senior Vice President, Vice President, and Treasurer of the NASD~~. All such officers shall have such titles, powers, and duties, and shall be entitled to such compensation, as shall be determined from time to time by the Board. Each such officer shall hold office until a successor is elected and qualified or until such officer's earlier resignation or removal. Any officer may resign at any time upon written notice to the ~~NASD~~Corporation.

ARTICLE IX

COMMITTEES

Appointment

Sec. 1.

(a) The Corporation shall have the following committees of the Board: the NASD Group Committee (during the Transitional Period); the NYSE Group Committee (during the Transitional Period); the Small Firm Governor Committee; and the Large Firm Governor Committee, which in each case shall be comprised of the Governors specified herein and in the Restated Certificate of Incorporation to be the members thereof and shall have the authority provided for herein and in the Restated Certificate of Incorporation. The Corporation shall also have the following committees: the Audit Committee, the Finance Committee and, during the first year of the Transitional Period or as extended thereafter by resolution of the Board, the Integration Committee, which in each case shall have the authority provided for herein.

(b) Subject to Article VII, Section 1(c), the Board may appoint such other committees or subcommittees as it deems necessary or desirable, and it shall fix their powers, duties, and terms of office in a manner not inconsistent with these By-Laws or the Restated Certificate of Incorporation. Any such other committee or subcommittee consisting solely of one or more Governors, to the extent provided by these By-Laws or by resolution of the Board and to the

extent not inconsistent with these By-Laws or the Restated Certificate of Incorporation, shall have and may exercise all powers and authority of the Board in the management of the business and affairs of the ~~NASD~~Corporation. Any such other committee having the authority to exercise the powers and authority of the Board shall have a ~~percentage of Non-Industry committee members at least as great as the percentage of Non-Industry Governors on the Board and a percentage of Public committee members at least as great as the percentage of Public Governors on the Board~~number of Public Governors as members thereof in excess of the number of Industry Governors which are members thereof. During the Transitional Period, all committees of the Board having the authority to exercise the powers and authority of the Board (with the exception of the Large Firm Governor Committee, the Small Firm Governor Committee, the NASD Group Committee and the NYSE Group Committee), shall also have (i) a percentage of members (to the nearest whole number of committee members) that are members of the NASD Group Committee at least as great as the percentage of Governors on the Board that are members of the NASD Group Committee; and (ii) a percentage of members (to the nearest whole number of committee members) that are members of the NYSE Group Committee at least as great as the percentage of Governors on the Board that are members of the NYSE Group Committee.

Maintenance of Compositional Requirements of Committees

Sec. 2. Upon request of the Secretary of the ~~NASD~~Corporation, each prospective committee member who is not a Governor shall provide to the Secretary such information as is reasonably necessary to serve as the basis for a determination of the prospective committee member's classification as an Industry~~, Non-Industry,~~ or Public committee member. The Secretary shall certify to the Board each prospective committee member's classification. Each committee member shall update the information submitted under this Section at least annually and upon request of the Secretary of the ~~NASD~~Corporation, and shall report immediately to the Secretary any change in such classification.

Removal of Committee Member

Sec. 3. A member of the Audit Committee, the Finance Committee (other than the Chair thereof) or a committee or subcommittee appointed pursuant to Section 1(b) of this Article may be removed from such committee or subcommittee only by a majority vote of the whole Board, after appropriate notice, for refusal, failure, neglect, or inability to discharge such member's duties.

Executive Committee

Sec. 4.

(a) The Board may appoint an Executive Committee, which shall, to the fullest extent permitted by the General Corporation Law of the State of Delaware and other applicable law, and subject to the Restated Certificate of Incorporation and these By-Laws, have and be permitted to exercise all the powers and authority of the Board in the management of the business and affairs of the ~~NASD~~Corporation between meetings of the Board, and which may authorize the seal of the ~~NASD~~Corporation to be affixed to all papers that may require it.

(b) The Executive Committee shall consist of no fewer than five and no more than eight Governors. The Executive Committee shall include the Chief Executive Officer of the ~~NASD, and at least one Director of NASD Regulation. The Executive Committee shall have a percentage of Non-Industry committee members at least as great as the percentage of Non-Industry Governors on the whole Board and a percentage of Public committee members at least as great as the percentage of Public Governors on the whole~~Corporation and the Chair of the Board.

(c) An Executive Committee member shall hold office for a term of one year.

(d) At all meetings of the Executive Committee, a quorum for the transaction of business shall consist of a majority of the Executive Committee, including not less than 50 percent of the ~~Non-Industry~~Public committee members. In the absence of a quorum, a majority of the committee members present may adjourn the meeting until a quorum is present.

Audit Committee

Sec. 5.

(a) The Board shall appoint an Audit Committee. The Audit Committee shall consist of four or five Governors, none of whom shall be officers or employees of the Association. ~~A majority of the Audit Committee members shall be Non-Industry Governors.~~ The Audit Committee shall include at least two Public Governors. A Public Governor shall serve as Chair of the Committee. An Audit Committee member shall hold office for a term of one year.

(b) The Audit Committee shall perform the following functions: (i) ensure the existence of adequate controls and the integrity of the financial reporting process of the ~~NASD~~Corporation; (ii) recommend to the ~~NASD~~ Board, and monitor the independence and performance of, the certified public accountants retained as outside auditors by the ~~NASD~~Corporation; and (iii) direct and oversee all the activities of the ~~NASD~~Corporation's internal review function, including but not limited to management's responses to the internal review function.

(c) No member of the Audit Committee shall participate in the consideration or decision of any matter relating to a particular ~~NASD~~ member, company, or individual if such Audit Committee member has a material interest in, or a professional, business, or personal relationship with, that member, company, or individual, or if such participation shall create an appearance of impropriety. An Audit Committee member shall consult with the General Counsel of the ~~NASD~~Corporation to determine if recusal is necessary. If a member of the Audit Committee is recused from consideration of a matter, any decision on the matter shall be by a vote of a majority of the remaining members of the Audit Committee.

(d) The Audit Committee shall have exclusive authority to: (i) hire or terminate the Director of Internal Review; (ii) determine the compensation of the Director of Internal Review; and (iii) determine the budget for the Office of Internal Review. The Office of Internal Review and the Director of Internal Review shall report directly to the Audit Committee. The Audit Committee may, in its discretion, direct that the Office of Internal Review also report to senior management of the ~~NASD~~Corporation on matters the Audit Committee deems appropriate and may request that senior ~~NASD~~ management perform such operational oversight as necessary and proper, consistent with preservation of the independence of the internal review function.

(e) At all meetings of the Audit Committee, a quorum for the transaction of business shall consist of a majority of the Audit Committee, including not less than 50 percent of the ~~Non-Industry~~Public committee members. In the absence of a quorum, a majority of the committee members present may adjourn the meeting until a quorum is present.

Finance Committee

Sec. 6.

(a) The Board ~~may~~shall appoint a Finance Committee. The Finance Committee shall advise the Board with respect to the oversight of the financial operations and conditions of the ~~NASD~~Corporation, including recommendations for the ~~NASD~~Corporation's annual operating and capital budgets and proposed changes to the rates and fees charged by ~~NASD~~Corporation.

(b) The Finance Committee shall consist of four or more Governors. The Chief Executive Officer of the ~~NASD~~Corporation shall be a member of the Finance Committee~~. The number of Non-Industry committee members shall equal or exceed the number of Industry committee members plus the Chief Executive Officer of the NASD~~. A Finance Committee member shall hold office for a term of one year.

(c) At all meetings of the Finance Committee, a quorum for the transaction of business shall consist of a majority of the Finance Committee, including not less than 50 percent of the ~~Non-Industry~~Public committee members. In the absence of a quorum, a majority of the committee members present may adjourn the meeting until a quorum is present.

(d) The Corporation shall also have an Investment Committee which shall not be a committee of the Board. The majority of the Investment Committee during the Transitional Period will be comprised of members of the Investment Committee immediately prior to the Closing, unless otherwise determined by the NASD Group Committee, and a minority of the Investment Committee during the Transitional Period will be comprised of members of the NYSE Group Committee.

Integration Committee

Sec. 7.

(a) The Board shall appoint an Integration Committee. The Integration Committee shall have a term not to exceed one year from the Closing unless continued for a longer period by resolution of the Board.

(b) The Chair of the Board shall be the Chair of the Integration Committee unless, in the case of the Integration Committee continuing beyond one year after Closing pursuant to Section 7(a), otherwise determined by the Board.

(c) At all meetings of the Integration Committee, a quorum for the transaction of business shall consist of a majority of the Integration Committee, including not less than 50 percent of the Public committee members. In the absence of a quorum, a majority of the committee members present may adjourn the meeting until a quorum is present.

ARTICLE XIII

POWERS OF BOARD TO IMPOSE SANCTIONS

Sec. 1. The Board is hereby authorized to impose appropriate sanctions applicable to members, including censure, fine, suspension, or expulsion from membership, suspension or bar from being associated with all members, limitation of activities, functions, and operations of a member, or any other fitting sanction, and to impose appropriate sanctions applicable to persons associated with members, including censure, fine, suspension or barring a person associated with a member from being associated with all members, limitation of activities, functions, and operations of a person associated with a member, or any other fitting sanction, for:

(a) breach by a member or a person associated with a member of any covenant with the ~~NASD~~Corporation or its members;

(b) violation by a member or a person associated with a member of any of the terms, conditions, covenants, and provisions of the By-Laws of the ~~NASD~~Corporation, NASD

Regulation, ~~Nasdaq,~~ or NASD Dispute Resolution, the Rules of the ~~Association~~Corporation, or the federal securities laws, including the rules and regulations adopted thereunder, the rules of the Municipal Securities Rulemaking Board, and the rules of the Treasury Department;

(c) failure by a member or person associated with a member to: (i) submit a dispute for arbitration as required by the Rules of the ~~Association~~Corporation; (ii) appear or produce any document in the member's or person's possession or control as directed pursuant to the Rules of the ~~Association~~Corporation; (iii) comply with an award of arbitrators properly rendered pursuant to the Rules of the ~~Association~~Corporation, where a timely motion to vacate or modify such award has not been made pursuant to applicable law or where such a motion has been denied; or (iv) comply with a written and executed settlement agreement obtained in connection with an arbitration or mediation submitted for disposition pursuant to the Rules of the ~~Association~~Corporation;

(d) refusal by a member or person associated with a member to abide by an official ruling of the Board or any committee exercising powers assigned by the Board with respect to any transaction which is subject to the Uniform Practice Code; or

(e) failure by a member or person associated with a member to adhere to any ruling, order, direction, or decision of or to pay any sanction, fine, or costs imposed by the Board or any entity to which the Board has delegated its powers in accordance with the Delegation Plan.

ARTICLE XV

LIMITATION OF POWERS

Conflicts of Interest

Sec. 4. (a) A Governor or a member of a committee shall not directly or indirectly participate in any adjudication of the interests of any party if such Governor or committee member has a conflict of interest or bias, or if circumstances otherwise exist where his or her fairness might reasonably be questioned. In any such case, the Governor or committee member shall recuse himself or herself or shall be disqualified in accordance with the Rules of the ~~Association~~Corporation.

(b) No contract or transaction between the ~~NASD~~Corporation and one or more of its Governors or officers, or between the ~~NASD~~Corporation and any other corporation, partnership, association, or other organization in which one or more of its Governors or officers are directors or officers, or have a financial interest, shall be void or voidable solely for this reason if: (i) the material facts pertaining to such Governor's or officer's relationship or interest and the contract or transaction are disclosed or are known to the Board or the committee, and the Board or committee in good faith authorizes the contract or transaction by the affirmative vote of a majority of the disinterested Governors, even though the disinterested governors be less than a quorum; or (ii) the material facts are disclosed or become known to the Board or committee after the contract or transaction is entered into, and the Board or committee in good faith ratifies the contract or transaction by the affirmative vote of a majority of the disinterested Governors even though the disinterested governors be less than a quorum. Only disinterested Governors may be counted in determining the presence of a quorum at the portion of a meeting of the Board or of a committee that authorizes the contract or transaction. This subsection shall not apply to any contract or transaction between the ~~NASD~~Corporation and NASD Regulation, ~~Nasdaq~~, or NASD Dispute Resolution.

ARTICLE XXI

MEETINGS OF MEMBERS

Annual Meeting

Sec. 1. The annual meeting shall be on such date and at such place as the Board shall designate; provided, however, that, except for the first annual meeting following the Closing at which Large Firm Governors, the Mid-Size Governor and Small Firm Governors shall be elected, there shall be no annual meetings of members during the Transitional Period. The business of the meeting shall include: (a) election of the members of the Board pursuant to Article VII, Section 13; and (b) the proposal of business (i) by or at the direction of the ~~Chairman~~Chief Executive Officer of the ~~Board~~Corporation or the Board, or (ii) by any member entitled to vote at the meeting who complied with the notice procedures set forth in Section 3 and was a member at the time such notice was delivered to the Secretary of the ~~NASD~~Corporation.

ARTICLE XXII

TRANSITIONAL PERIOD

Notwithstanding anything herein to the contrary, to the extent there is any inconsistency between the other provisions of these By-Laws, including, without limitation, Sections 1, 4, 5 and 9 of Article VII hereof, and this Article XXII, the provisions of this Article XXII shall govern as of Closing and for the Transitional Period to the fullest extent permitted by applicable law:

Powers and Authority of Board

Sec. 1.

The Board shall be the governing body of the Corporation and, except as otherwise provided by applicable law, the Restated Certificate of Incorporation, or these By-Laws, shall be vested with all powers necessary for the management and administration of the affairs of the Corporation and the promotion of the Corporation's welfare, objects, and purposes; provided, however, that (i) during the Transitional Period, the Board, after consultation with the Chief Executive Officer of the Corporation, shall have the exclusive authority to appoint any Lead Governor of the Corporation, (ii) during the Transitional Period, the Board, after receiving the recommendation of the Chief Executive Officer, shall have the exclusive authority to appoint the Chair of the Finance Committee and (iii) during the Transitional Period, the Nominating Committee will be jointly populated by the Chief Executive Officer and the Chief Executive Officer of NYSE Regulation, Inc. as of Closing (or his duly appointed or elected successor as Chair of the Board), subject to ratification of the appointees by the Board.

Composition and Qualifications of the Board

Sec. 2.

(a) As of Closing, and for the Transitional Period, the Board shall consist of 23 authorized members, consisting of (i) the Chief Executive Officer of the Corporation, (ii) the Chief Executive Officer of NYSE Regulation, Inc., (iii) eleven Public Governors, (iv) a Floor Member Governor, an Independent Dealer/Insurance Affiliate Governor and an Investment Company Affiliate Governor and (v) three Small Firm Governors, one Mid-Size Firm Governor and three Large Firm Governors; provided, however that the Board shall not include such Small Firm Governors, Mid-Size Firm Governor or Large Firm Governors, but rather shall include three

persons, who immediately prior to the Closing are Industry Governors, selected by the Board in office prior to the Closing, three persons, who immediately prior to the Closing qualified as Industry Governors pursuant to the By-Laws in existence prior to the Closing, selected by the Board of Directors of NYSE Group, Inc. and one person, who immediately prior to the Closing qualified as an Industry Governor pursuant to the By-Law in existence prior to the Closing, selected by the Board of Directors of NYSE Group, Inc. and the Board of Governors in office prior to the Closing jointly, until the election of such Small Firm Governors, Mid-Size Firm Governor and Large Firm Governors at the first annual meeting of members following the Closing (which shall be held as soon as practicable after the Closing).

(b) During the Transitional Period, the Chair shall be the Chief Executive Officer of NYSE Regulation, Inc. as of Closing so long as he remains a Governor. In the event the Chief Executive Officer of NYSE Regulation, Inc. as of the Closing ceases to be Chair during the Transitional Period, subject to the Restated Certificate of Incorporation and these By-Laws, the Chair shall be selected by the NYSE Group Committee from among its members; provided that the Chair so selected shall not be a member of the Board of Directors of NYSE Group, Inc.

Term of Office of Governors

Sec. 3.

Upon the Closing, the term of office of each Governor in office immediately prior to the Closing who is not to be a Governor as of Closing pursuant to this Article XXII shall automatically, and without any further action, terminate, and such persons shall no longer be members of the Board of Governors.

The Chief Executive Officer shall serve as a Governor until a successor is elected, or until death, resignation, or removal.

The Chief Executive Officer of NYSE Regulation, Inc. as of Closing shall serve as a Governor during the Transitional Period, until death, resignation, or removal; provided, however, in the event of a vacancy during the Transitional Period with respect to this Governor position by virtue of death, resignation or removal, the then Chief Executive Officer of NYSE Regulation, Inc. shall serve as a Governor for the remainder of the Transitional Period, until death, resignation or removal; provided, further however, a person who becomes a Governor pursuant to the immediately preceding proviso shall not be qualified to serve as Chair.

Effective as of Closing, the Board of Directors of NYSE Group, Inc. shall appoint the NYSE Public Governors, the Board in office prior to the Closing shall appoint the NASD Public Governors and the Board of Directors of NYSE Group, Inc. and the Board in office prior to the Closing jointly shall appoint the Joint Public Governor.

The Public Governors appointed in accordance with the preceding paragraph shall hold office for the Transitional Period, or until death, resignation, disqualification, or removal. In the event of any vacancy among the NYSE Public Governors, the Joint Public Governor or NASD Public Governors during the Transitional Period, such vacancy shall only be filled by, and nominations for persons to fill such vacancy shall be made by, the NYSE Group Committee in the case of a vacant NYSE Public Governor position, such vacancy shall only be filled by the Board, and nominations for persons to fill such vacancy shall be made by the Nominating Committee, in the case of a vacant Joint Public Governor position or such vacancy shall only be filled by, and nominations for persons to fill such vacancy shall be made by, the NASD Group Committee in the case of a vacant NASD Public Governor position.

Effective as of Closing, the Board of Directors of NYSE Group, Inc. shall appoint the Floor Member Governor, the Board of Governors in office prior to the Closing shall appoint the Independent Dealer/ Insurance Affiliate Governor and the Board of Directors of NYSE Group, Inc. and the Board of Governors in office prior to the Closing jointly shall appoint the Investment Company Affiliate Governor.

The Floor Member Governor, the Investment Company Affiliate Governor and the Independent Dealer/Insurance Affiliate Governor appointed in accordance with the preceding paragraph shall hold office for the Transitional Period, or until death, resignation, disqualification, or removal. In the event of any vacancy among the Floor Member Governor, the Investment Company Affiliate Governor or the Independent Dealer/Insurance Affiliate Governor during the Transitional Period, such vacancy shall only be filled by, and nominations for persons to fill such vacancy shall be made by, the NYSE Group Committee in the case of a Floor Member Governor vacancy, such vacancy shall only be filled by the Board, and nominations for persons to fill such vacancy shall be made by the Nominating Committee, in the case of an Investment Company Affiliate Governor vacancy or such vacancy shall only be filled by, and nominations for persons to fill such vacancy shall be made by, the NASD Group Committee in the case of an Independent Dealer/Insurance Affiliate Governor vacancy.

Three Large Firm Governors, three Small Firm Governors and one Mid-Size Governor shall be elected as Governors at the first annual meeting of members following the Closing (the "Initial Member Elected Governors"). The Initial Member Elected Governors shall hold office until the first annual meeting of members following the Transitional Period, or until a successor is duly elected and qualified, or until death, resignation, disqualification, or removal.

In the event of any vacancy among the Large Firm Governors, the Mid-Size Firm Governor or the Small Firm Governors during the Transitional Period, such vacancy shall only be filled by, and nominations for persons to fill such vacancy shall be made by, the NYSE Group Committee in the case of a Large Firm Governor vacancy, such vacancy shall only be filled by the Board, and nominations for persons to fill such vacancy shall be made by the Nominating Committee, in the case of a Mid-Size Firm Governor vacancy or such vacancy shall only be filled by, and nominations for persons to fill such vacancy shall be made by, the NASD Group Committee in the case of a Small Firm Governor vacancy; provided, however, that in the event the remaining term of office of any Large Firm, Mid-Size Firm or Small Firm Governor position that becomes vacant is for more than 12 months, nominations shall be made as set forth above in this paragraph, but such vacancy shall be filled by the members entitled to vote thereon at a meeting thereof convened to vote thereon.

Upon the expiration of the Transitional Period, the term of office of the Chief Executive Officer of NYSE Regulation, Inc. as a member of the Board shall automatically, and without any further action, terminate, such person shall no longer be a member of the Board and the authorized number of members of the Board shall automatically be reduced by one.

Nominations at the First Annual Meeting Following Closing

Sec. 4.

In the case of the first annual meeting of members following the Closing, nominations shall be by the Board of Directors of NYSE Group, Inc. with respect to Large Firm Governors, jointly by the Board of Directors of NYSE Group, Inc. and the Board in office prior to the Closing with respect to the Mid-Size Firm Governor and by the Board in office prior to the Closing with respect to Small Firm Governors, instead of the Nominating Committee.

EXHIBIT 3

Last Updated: 1/3/07

Regulatory Consolidation - Assertions and Facts

NASD member firms have been receiving numerous communications about the recently announced regulatory consolidation plan from sources other than NASD. NASD believes that some of those communications contain misstatements of fact, and would like to set the record straight to ensure that all members have access to accurate information and a fair voting process.

One-Time $35,000 Payment to Member Firms

Assertion:

NASD can increase the amount of the $35,000 one-time payment due to all member firms if the consolidation is approved. A much larger payment can and should be made.

Fact:

A larger payment isn't possible. NASD is a tax-exempt organization and therefore is limited by tax laws regarding the size and source of payments it can make to its members. Since its founding almost 70 years ago, NASD has been defined by its corporate charter as a not-for-profit organization and has been recognized as a tax-exempt organization under section 501(c) (6) of the Internal Revenue Code. As a tax-exempt not-for-profit, NASD is prohibited from paying dividends and is constrained in making other payments to members.

The payment of $35,000 per member firm, or a total of $178 million, will be funded by—and therefore limited by—the expected value of the incremental cash flows that will be produced by the consolidation transaction. A higher payment would seriously jeopardize NASD's status as a tax-exempt organization, which would result in significantly higher fees for firms. Since the $35,000 payment is based on expected positive cash flows from the transaction, without the transaction, there can be no payment at all.

Assertion:

The NASD will pay NYSE member firms $103 million to secure this plan—or $515,000 per NYSE member firm—plus the $35,000 NASD-regulated firms will receive.

Fact:

NYSE member firms will NOT receive any part of the $103 million payment that NASD is making to the NYSE Group (a public company). The $103 million payment is designed to compensate the NYSE for revenue streams that it is transferring to NASD and the positive cash flows that we expect to generate from this transaction; it also makes the deal revenue-neutral to NYSE shareholders.

It is our belief that, through attrition and consolidation of organizational assets such as technology platforms and back office systems, we will generate positive cash flows from this deal for the foreseeable future. Also, value derived from the transaction also will go back to the membership through the one-time payment of $35,000, the planned reduction of the Gross Income Assessment and targeted fee reductions beginning in the third year of the transaction.

Assertion:

NASD could pay each member firm $35,000 immediately—whether or not the consolidation plan is approved.

Fact:

The unique circumstances of the consolidation allow NASD to make a one-time distribution to each member firm once the transaction closes. In addition, the $35,000 payment to each member firm reflects anticipated values that will be generated only if NASD and NYSE Regulation are combined. If there is no transaction, there is no payment.

Assertion:

NASD could pay each member firm a total of $100,000 over a three-year period.

Fact:

NASD cannot and will not pay each member firm a total of $100,000 over a three-year period. The unique circumstances of the consolidation allow NASD to make a one-time payment to each member firm of $35,000. A payment of $35,000 per member firm—for a total of $178 million—is the maximum amount NASD can distribute to members in connection with this transaction and still retain its 501(c)(6) tax-exempt status. Also, the Gross Income Assessment will be reduced by $1,200 per firm for five years, subject to annual Board approval; this reduction amounts to nearly $31 million in additional member savings that will result from this transaction.

Assertion:

There is no binding agreement to pay any member any sum of money.

Fact:

This statement is nothing more than an attempt to confuse members about the facts. The fact is that NASD has publicly promised to pay each member firm $35,000 once the By-Law amendments are approved and the transaction closes. NASD stands by that promise as well as its promise to reduce the Gross Income Assessment by $1,200 for each firm for the next five years, subject to annual Board approval.

Regulatory Changes

Assertion:

After the consolidation, the new SRO will increase the net capital requirement for all member firms.

Fact:

The new SRO will NOT raise the net capital requirement for firms. In 2005, NASD convened an industry task force to look at issues related to net capital. The task force concluded its discussions early this year and NASD decided not to change the net capital requirement. NASD's current minimum net capital requirement reflects SEC Rule 15c3-1 (the Net Capital Rule)—and while the SEC has the authority to change the net capital requirement, we do not believe that they would take that action.

Assertion:

After consolidation, firms that are currently regulated only by NASD will be subject to NYSE rules.

Fact:

There will be no new requirements placed on NASD-only member firms as a result of the consolidation. If you are an NASD-only member, you will continue to need to comply with NASD (not NYSE) rules. If you are a joint NASD/NYSE member, we will work, over time, to consolidate the rules that apply to you to have only one set of rules.

We plan to set up industry committees, and use our existing committee structure, to guide us through any changes. The industry will have a lot of input into the process.

Governance

Assertion:

The new SRO could have preserved NASD's current "one-member, one vote" structure.

Fact:

Given our negotiations with the NYSE—and the trend toward purely public representation on regulatory boards—we believe that we achieved the best possible outcome for the membership. As you know, the SEC is very comfortable with the approach of no industry on the boards of SROs—and the risk of losing industry representation has become greater and greater. But we made it clear that we would not do this transaction without broad industry representation in the governance. While it is true that each member will not be entitled to vote for every member of the Board of Governors if the consolidation is approved, member firms are guaranteed to have a strong position on the board and each member firm will still get one vote for all:

- By-Law changes,
- District committee elections, and
- Board elections in their firm category.

Assertion:

The balance of small and large firms on the proposed Board of Governors is unfair to small firms.

Fact:

Quite the opposite is true. The consolidation gives small firms three guaranteed seats on the Board of Governors, which is the same amount as large firms and more than small firms currently are guaranteed on the NASD Board. The consolidation preserves industry representation in the SRO process and guarantees that firms of all sizes will have a significant voice in the governance of the new SRO. In negotiating the transaction, NASD's leadership insisted on industry representation and, in particular, on guaranteed small firm representation. The governance structure achieves those critical goals and is fair and balanced.

Assertion:

The proposed governance changes will effectively restrict the rights of NASD member firms.

Fact:

Quite the opposite. NASD was absolutely determined to have broad industry representation—and small firm representation in particular—and we negotiated the best possible agreement to preserve our bedrock principle of industry participation. Each member firm will still get one vote for all:

- By-Law changes,
- District committee elections, and
- Board elections in their firm category.

General/Miscellaneous

Assertion:

NASD is rushing its members to vote on the proposed By-Law amendments before they have had ample opportunity to review them.

Fact:

NASD is not rushing the vote. We are committed to full disclosure and answering member questions about the consolidation plan and its implementation—including the By-Law amendments that are needed and the special member meeting that will be held. NASD senior officials traveled to 26 cities in less than 3 weeks to

meet with members to provide more information and answer questions about the consolidation. All members received (by mail) a detailed information package about the plan and the By-Law amendments that will be voted on by firms. Members have a voting period of more than 30 days, which is in accordance with NASD's By-Laws and consistent with past NASD member votes.

Assertion:

Small firms will be better off if they reject this deal.

Fact:

If NASD member firms don't vote to approve the By-Law amendments needed to effectuate this deal, there can be no assurances about the shape of self-regulation moving forward. The SEC is committed to ending redundant, inefficient regulation, and this can be achieved through the consolidation plan that the NASD Board of Governors overwhelmingly approved. For example, the SEC recently approved the NYSE's governance structure—which prohibits all industry participation at the board level—as fair representation of the industry. The SEC could choose other ways to change the SRO system that would not permit the broad industry participation of the current plan.

EXHIBIT 4

News Release

For Release: Friday, March 16, 2007
Contacts: Nancy Condon (202) 728-8379
Herb Perone (202) 728-8464

Schapiro Announces Leadership and Structural Moves for New, Consolidated SRO

Reorganized Member Regulation, Enforcement and Dispute Resolution Operations to Form Foundation for Ongoing Integration Efforts

Washington, D.C. — With the formal consolidation of NASD and New York Stock Exchange Member Regulation on schedule for the second quarter, NASD Chairman and CEO Mary L. Schapiro today announced a number of important structural and organizational moves for the new SRO, focusing on the core areas of member regulation, enforcement, dispute resolution and technology.

These moves will serve as the foundation for joining the two entities into a single regulatory body. Integration efforts and analysis are being led by a committee of senior executives from both organizations, headed by NASD's Stephen Luparello and NYSE Regulation's Susan Axelrod.

"This is an exciting time not just for our two organizations, but for the firms we regulate and the investors we serve," said Schapiro, who will serve as CEO of the new, as yet unnamed SRO. "When our new SRO is in place, regulation will be more sensible, more efficient and more effective. Both organizations are blessed with talented, experienced individuals, and the announcement today demonstrates the commitment the new SRO will have to maximizing the expertise of these individuals."

Specifically, the changes announced today are:

Member Regulation

The new SRO's Member Regulation function will be split into two departments. Grace Vogel, who currently heads Member Firm Regulation at NYSE Regulation, will head the new SRO's Department of Risk Oversight and Operational Regulation, building on NYSE Regulation's Financial Operations expertise. Robert Errico, who currently heads Member Regulation at NASD, will lead the Department of Sales Practice Regulation, which will leverage the NASD District Office structure and NYSE Regulation's Sales Practice Review Unit in focusing on the wide range of issues involving the financial industry's relationship with the investing public. "Grace and Bob will work together closely to ensure that the new SRO speaks with a single voice in its regulatory interactions with firms," Schapiro said.

Enforcement

The enforcement departments of both organizations will be fully integrated into a single Enforcement Department. Susan Merrill, who is in charge of Enforcement at NYSE Regulation, will be Chief of the combined operation and will be based in New York. NASD's current Enforcement chief, James Shorris, will serve as Executive Director and will be based in Washington.

Member Regulation, Enforcement and NASD's existing Market Regulation Department will report to Luparello.

Emerging Issues

NYSE Regulation's Office of Risk Assessment and the NASD Office of Emerging Issues will be combined into a single group, which will report to Elisse Walter, who currently oversees regulatory policy and programs at NASD. Investment Company Regulation, Investor Education, Corporate Finance, Advertising and Member Education will also report to Walter.

Dispute Resolution

Linda Fienberg, who runs NASD Dispute Resolution, will head the new SRO's Office of Dispute Resolution, which will combine NYSE Regulation's arbitration program with NASD's arbitration and mediation programs.

Technology

The integration of the two organizations' technology portfolios will be led by NASD's Chief Technology Officer, Marty Colburn, supported by NYSE's Angela Posillico.

Technology, as well as Strategy, Registration and Disclosure, Testing and Continuing Education, Member Relations, Transparency Services and International will continue to report to NASD's Doug Shulman.

Investor protection. Market integrity. 1735 K Street, NW Washington, DC 20006-1506 tel 202 728 8000 www.nasd.com

EXHIBIT 5

SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

Charles Edward Ramos **53**

PRESENT: _____ PART _____

Justice

_____

INDEX NO. _____

Index Number : 602510/2005

WEY, ALLISON L.

MOTION DATE _____

vs

NEW YORK STOCK EXCHANGE

MOTION SEQ. NO. _____

Sequence Number : 002

MOTION CAL. NO. _____

SUMMARY JUDGMENT

this motion to/for _____

	PAPERS NUMBERED
Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...	_____
Answering Affidavits — Exhibits _____	_____
Replying Affidavits _____	_____

Cross-Motion: ☐ Yes ☐ No

Upon the foregoing papers, it is ordered that this motion

Motion is decided in accordance with accompanying Memorandum Decision.

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

Dated: 4/10/07

CHARLES E. RAMOS

Check one: ☐ FINAL DISPOSITION ☒ NON-FINAL DISPOSITION

Check if appropriate: ☐ DO NOT POST ☐ REFERENCE

SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: Charles Edward Ramos PART 53

Justice

Index Number : 602510/2005
WEY, ALLISON L.
vs
NEW YORK STOCK EXCHANGE
Sequence Number : 003
PRECLUDE

INDEX NO. _____
MOTION DATE _____
MOTION SEQ. NO. _____
MOTION CAL. NO. _____

this motion to/for _____

	PAPERS NUMBERED
Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...	
Answering Affidavits — Exhibits	
Replying Affidavits	

Cross-Motion: ☐ Yes ☐ No

Upon the foregoing papers, it is ordered that this motion

MOTION IS DECIDED IN ACCORDANCE WITH ACCOMPANYING MEMORANDUM DECISION IN MOTION SEQUENCE ...2...

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

Dated: 4/10/07

CHARLES E. RAMOS J.S.C.

Check one: ☐ FINAL DISPOSITION ☒ NON-FINAL DISPOSITION

Check if appropriate: ☐ DO NOT POST ☐ REFERENCE

SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: Ramos PART 53m

Justice

Allison L. Wey

INDEX NO. 602510/05

MOTION DATE

- v -

MOTION SEQ. NO. 005

The New York Stock Exchange

MOTION CAL. NO.

The following papers, numbered 1 to _____ were read on this motion to/for _____

	PAPERS NUMBERED
Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...	
Answering Affidavits — Exhibits	
Replying Affidavits	

Cross-Motion: ☐ Yes ☐ No

Upon the foregoing papers, it is ordered that this motion

MOTION IS DECIDED IN ACCORDANCE WITH ACCOMPANYING MEMORANDUM DECISION IN MOTION SEQUENCE ..2..

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

Dated: 4/10/07

CHARLES E. RAMOS J.S.C.

Check one: ☐ FINAL DISPOSITION ☑ NON-FINAL DISPOSITION

Check if appropriate: ☐ DO NOT POST ☐ REFERENCE

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL DIVISION

----------X

ALLISON L. WEY,

Plaintiff,

-against- Index No. 602510/05

THE NEW YORK STOCK EXCHANGE, INC.
and JOHN THAIN,

Defendants.

----------X

Charles Edward Ramos, J.S.C.:

In motion 02, defendants, the New York Stock Exchange ("NYSE" or the "Exchange") and John Thain move, pursuant to CPLR 3212, for summary judgment, dismissing the complaint of plaintiff, Allison L. Wey.

In motion 03, defendants move to limit plaintiff's damages evidence at trial.

In motion 05, defendants move for a preliminary injunction restraining plaintiff's counsel Mark Krum from making statements to the press allegedly impugning the character, credibility and reputation of Mr. Thain and sanctioning plaintiff's counsel for making such statements in violation of New York's Code of Professional Responsibility. Defendants also seek relief arising from Mr. Krum's disclosure to the press of a document defendants marked "confidential" allegedly in violation of the parties' confidentiality agreement.

Background

Ms. Wey's family owned a seat on the NYSE for many years. Ms. Wey is married to Richard Wey, a floor trader at the NYSE for Bear Wagner Specialists, LLC ("Bear Wagner"). In 2000, plaintiff

purchased the seat from her father for $1,100,000. She leased the seat to Bear Wagner and finally sold her seat on March 21, 2005 for $1,540,000.

The NYSE was a not-for-profit organization until March 7, 2006. The owners of the NYSE were 1,366 "seatholders". Mr. Thain has been the NYSE's Chief Executive Officer since January 15, 2004 for the (then non-profit) NYSE, and currently holds the same titles for NYSE Group, Inc., a for-profit, publicly traded entity. On April 20, 2005, approximately one month after Ms. Wey sold her seat, the NYSE announced that it would merge. Immediately thereafter, on April 25, 2005, a seat on the NYSE sold for $2,400,000. Seat prices stayed in that range until July 2005. Sixty seats were sold between April 20, 2005 and December 31, 2005.

Merger Negotiations

On January 5, 2005, Archipelago Holdings LLC ("Archipelago"), through the investment bank Goldman Sachs ("Goldman"), approached the NYSE for the first time to inquire whether the NYSE would meet with Archipelago to consider a possible transaction. In January 2005, Mr. Thain and Gerald Putnam, Archipelago's CEO, spoke (at least twice) regarding the general outlines of a possible transaction. Thain 10/26/05 Dep. at 41:19-44:10. A number of meetings followed. David Schwimmer, an investment banker at Goldman who acted as facilitator to the transaction, also attended a number of these meetings with Thain and Putnam. Id. at 41:11-18.

On February 3, 2005, NYSE management briefed the NYSE board of directors on the status of its evaluation of possible strategic alternatives, including its preliminary discussions with Archipelago. NYSE Group, Inc., SEC Registration Statement filed 11/3/05 at 59.

On February 10, 2005, NYSE and Archipelago entered into a confidentiality agreement, making it possible for non-public information designated as confidential to be exchanged for the first time. See Confidentiality Agreement dated 2/10/05.

On February 14, 2005, preliminary due diligence between the NYSE and Archipelago began. NYSE Group, Inc., SEC Registration Statement filed 11/3/05 at 61, 63. Due Diligence continued for over two months. See Goldman Sachs Proposed Time-line dated March 29, 2005.

The Meeting

Meanwhile, on February 15, 2005, Mr. Wey attended a closed-door, invitation only breakfast meeting[1] where Mr. Thain was to have an open dialogue with "working members"[2] of the exchange.[3]

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[1] According to the breakfast meeting memo of February 15, 2005, the invitees and their backgrounds are as follows: Jim McDevitt (specialist), Rick Wey (specialist, owns seat), Glenn Carell (specialist), Rich Como (top floor broker), Frank Cataldo (independent seat owner), Larry Lograno (runs floor for Wachovia), Dan Tandy (runs direct access firm), Randy Beller (broker), Mike O'Conner (specialist), Steve Steinthal (specialist).

[2] The memo refers to "floor members" while Mr. Tandy used the term "working members" during his deposition.

[3] Seatholders on the NYSE were also referred to as "members" of the NYSE. "Working members" hold seats and work on the floor of the exchange.

Daniel Tandy[4] 6/13/06 Dep. at 116:15-117:21. Mr. Wey attended the breakfast meeting for the sole purpose of asking Mr. Thain if the NYSE was going public, and based on the answer, would make an informed decision, along with his wife, whether or not to sell her seat. R. Wey 8/8/06 Dep. at 106:5-8; A. Wey 9/12/06 Dep., 247:10-248:11; 477:20-479:21. Mr. Wey testified that during the breakfast meeting, he asked Mr. Thain "Are we going public?" Mr. Thain responded, "our first priority is hybrid trading." R. Wey 8/8/06 Dep., 223:15-16. Mr. Wey again posed the question "I understand your concerns there, but are we (the NYSE) going public?" Id. at 225:18-19. Mr. Thain responded "No, we're not going public. The guys on Wall Street and Broad don't get it. It would take one to two years for us to go public, and there are no plans for that to happen." Id. at 226:5-8. Mr. Thain has no specific recollection of Mr. Wey's questions nor of his own responses at the breakfast meeting. Thain 8/9/06 Dep., 18:2-10.

The Merger

Under the merger plan with Archipelago, seatholders were entitled to receive $300,000 in cash and 80,177 shares of NYSE Group, subject to a variety of lock-up restrictions.[5] Seatholders could also make a cash election or a stock election. On March 10, 2006, each seatholder as of March 6, 2006 was paid

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[4] Daniel Tandy is a former member of the NYSE's Board of Executives and helped select invitees to the 2/15/05 breakfast meeting.

[5] Trading opened at $67 per share and increased to approximately $100 where it remains today.

$70,570.78 in dividends per seat owned.

On July 13, 2005, the day after the complaint was filed, a seat was sold for $2,410,000. However, plaintiff's expert, Mr. Pomerantz, seeks to measure damages by the difference between the price of plaintiff's seat in March 2005 (when she sold it) and the price of NYSE Group shares in May 2006, November 2006, March 2008 and March 2009. Among other things, Mr. Pomerantz assumes that Ms. Wey would not have sold her seat before December 31, 2005 because only 60 seatholders, or less than 5%, sold their seats during that period after the merger announcement up to December 31, 2005.

Plaintiff alleges claims for fraudulent misrepresentation, negligent misrepresentation and breach of fiduciary duty.

Summary Judgment Standard

In order to grant summary judgment, the court must determine whether a material and triable issue of fact exists. *See Sillman v Twentieth Century-Fox Film Corp.*, 3 NY2d 395, Rehearing denied, 3 NY2d 941 (1957). After the movant makes a prima facie case, the burden shifts to the opposing party to produce evidentiary proof sufficient to establish the existence of a material issue of fact that requires a trial. *Winegrad v New York Medical Univ. Med. Cen.*, 64 NY2d 851 (1985). When deciding a motion for summary judgment, the court must view the evidence in a light most favorable to the party opposing the motion and must give that party the benefit of every inference which can be drawn from the evidence. *See Assaf v Topog. Cab Corp.*, 153 AD2d 520 (1st

Dept 1989).

However, on a motion for summary judgment to dismiss the complaint, if it is determined that due to a lack of competent evidence, no reasonable jury could conclude the allegations, dismissal may be appropriate for lacking a material issue in dispute. See *Speller v Sears, Roebuck & Co.*, 100 NY2d 38 (2003).

Fraudulent Misrepresentation

In order to prove fraudulent misrepresentation, plaintiff must be able to show that the (1) defendants made a material false representation; (2) defendants intended to defraud the plaintiff thereby; (3) plaintiff reasonably relied upon the representation; and (4) plaintiff suffered damage as a result of the reliance. *J.A.O. Acquisition Corp. v Stavitsky*, 18 AD3d 389 (1st Dept 2005).

Plaintiff asserts that as to the second and third elements (intent to defraud and reasonable reliance) she will prove at trial that Mr. Thain had reason to expect Ms. Wey, who was not at the February meeting, to rely on Mr. Thain's statement to Mr. Wey and the others attending the meeting. Plaintiff, without citing one case, urges this Court to rely on the "reason to expect" theory of fraud under Restatement (Second) of Torts § 533 which provides:

> The maker of a fraudulent misrepresentation is subject to liability for pecuniary loss to another who acts in justifiable reliance upon it if the misrepresentation, although not made directly to the other, is made to a third person and the maker intends or has *reason to expect* that its terms will be repeated or its substance communicated to the other, and that it will *influence his conduct* in the transaction or type of transaction involved. *Emphasis*

supplied.

As defendants correctly point out, under this theory, plaintiff fails to demonstrate competent evidence that Mr. Thain had a reason to expect that Mr. Wey would communicate the statement to *this* particular plaintiff, his wife.

Mr. Wey, who attended the breakfast meeting, is not the owner of the seat, but was listed as "owns seat" on a memo given to Mr. Thain prior to the meeting. The breakfast memo listed the names and describing backgrounds of the invitees at the closed-door meeting. Such a memo was typically made available to Mr. Thain prior to the breakfast meeting. Thain 8/9/05 Dep., 43:24-45:8. It is an issue of fact whether the memo was reviewed by Mr. Thain before his statement to Mr. Wey. Thain Dep 8/9/05, 51:7-52:13. Although the memo listed Mr. Wey as owning a seat, the memo made no reference to Ms. Wey. Mr. Wey even admits that Mr. Thain had no knowledge of plaintiff's ownership of the seat or that she was thinking about selling it. R. Wey Dep., 222:13-223:3.

Furthermore, § 533 would require Mr. Thain's statement to "influence (plaintiff's) conduct" to sell her seat. Ms. Wey admits in her deposition that she had no reason to believe that Mr. Thain (through his statement) was trying to get her to sell her seat. A. Wey 9/12/06 Dep., 285:12-17.

The same outcome bars plaintiff's proposed application of Comment c. to § 533 which provides:

> The rule stated in this Section is applicable not only when the effect of the misrepresentation is to induce the other

> to enter into a transaction with the maker, but also when he is induced to enter into a transaction with a third person.

No evidence supplied by plaintiff suggests that Mr. Thain had a reason to expect that Ms. Wey would be induced to enter a transaction with a third person.

However, Restatement (Second) of Torts § 531, broadens the scope of § 533 to "class of persons" intended or reasonably expected to act in justifiable reliance on the statement. Defendants fail to address § 531. The Court agrees with plaintiff's proposed application of this provision of the Restatement. Restatement (Second) of Torts § 531 provides:

> One who makes a fraudulent misrepresentation is subject to liability to the persons or *class of persons whom he intends or has reason to expect to act . . . in reliance* upon the misrepresentation, for pecuniary loss suffered by them through their justifiable reliance in the type of transaction in which he intends or has reason to expect their conduct to be influenced. *Emphasis supplied.*

The Court finds that a reasonable jury could conclude that Mr. Thain had reason to expect that his statement about the future of the NYSE to a group of "floor traders," some of which Mr. Thain knew currently owned seats on the exchange, would be justifiably influenced to act (i.e. trade, etc) in reliance on the statement. Therefore, triable issues of material fact exist and the claim must be determined by a fact finder.

This Court is not alone in relying on § 531 under similar circumstances. Indeed, its application in New York has a long history. Federal courts applying New York law, as well as New York courts have applied the "class of persons" expansion to fraudulent misrepresentation claims.

In *Greene v Mercantile Trust Co.*, 60 Misc. 189 (Sup. Ct, Erie County, affirmed, 128 AD 914 (4th Dept 1908), plaintiff's action for fraud and deceit was upheld against defendant corporation for inducing him to purchase shares of the corporation by means of false and fraudulent misrepresentations in a prospectus. The court opined:

> "where one makes false representations, known to be such and intended to influence another, and which come to the latter's knowledge, and in reliance on which he in good faith parts with property or incurs an obligation, the one making the representations renders himself liable for the damages sustained, and it is not necessary that the representations be made to plaintiff personally; it being sufficient that they are made to the public at large for the purpose of influencing any one who may act on them."

Id. See also, *Brackett v Griswold*, 112 NY 454 (1889)(Court of Appeals applied a similar standard on a fraudulent misrepresentation claim regarding a false corporate prospectus).

In *Wechsler v Hoffman-LaRoche, Inc.*, 198 Misc. 540, (Sup. Ct, Bronx County 1950), a fraud claim was upheld by a third-party against a drug manufacturer that misrepresented the drug's fatal propensities to the prescribing doctor. The court opined:

> "Reliance upon fraudulent representations by persons who are not the direct addressees thereof but who may be intended or expected to learn of and act upon such representations will found an action in fraud and deceit."
> Id. at 590, *aff'd as modified*, 279 AD 654 (1951).

In *Ultramares Corp. v Touche*, 255 NY 170 (1931), Justice Cardozo explained that "[accountants] owed to their employer a duty imposed by law to make their certificate without fraud. . . to creditors and investors to whom the employer exhibited the certificate, since there was notice in the circumstances of its

making that the employer did not intend to keep it to himself." Id. at 179. See also, *Berkowitz v Baron*, 428 F Supp 1190 (SDNY 1977), (defendant knowingly participated in the issuance of a false and materially misleading accounting report of company upon which plaintiffs relied and bought stock; the court held "in order for [defendant] to be liable to these plaintiffs, they must be within the class of persons that [defendant] should reasonably have expected to rely on them"). Id. at 1196.

Applying the threshold requirement of *Ultramares*, in order for Mr. Thain to be liable to this plaintiff, Ms. Wey must be within the class of persons (seatholders on the exchange) that Mr. Thain should reasonably have expected to rely on his statements. See *American Elec. Power Co. v Westinghouse Elec. Corp.*, 418 F Supp. 435, 450 (SDNY 1976). Here, it is undisputed that Ms. Wey was in fact a seatholder at the time of Mr. Thain's statement. Therefore, a reasonable jury could conclude that Mr. Thain intended that seatholders, as a class, would reasonably rely on his statement.

As to the element of falsity, which includes not only that the statement was in fact false, but also that defendant had knowledge that the statement was false [*Gerald Modell, Inc. v Schraeder*, 6 Misc3d 1013A (Sup. Ct. NY County 2004)], defendants argue that there is no evidence that Thain intended to make a misrepresentation because he testified during his deposition that he thought his statement was true. Even though Mr. Thain claims to have no specific knowledge of Mr. Wey's question or his own

response at the breakfast meeting, Mr. Thain testified that he would have understood Mr. Wey's question, "are we going public" to be asking whether the NYSE was planning to undertake an initial public offering ("IPO"). Thain 8/9/06 Dep., 22:14-23:7.

In David Schwimmer's prior testimony in a related case[6] and his deposition in this case Mr. Schwimmer testified that at a meeting with Mr. Thain on January 24, 2005, he presented him with two "possible transaction structures that might work" between the NYSE and Archipelago. Schwimmer 12/8/06 Dep., 67:7-16; 68:3-7; Schwimmer Trial Testimony, November 14, 2005, *Higgins v The New York Stock Exchange*, 10 Misc. 3d 257, (Sup Ct, NY County, 2005, J. Ramos), 68:10-18. The first was an "outright acquisition" which would involve a "cash acquisition of Archipelago at a market cap plus a premium." Schwimmer Trial Testimony, 68:19-20; Schwimmer 12/8/06 Dep., 68:19-69:8. This structure would involve an initial public offering ("IPO") process, that would take unusually two to four years to complete. Schwimmer Trial Testimony, 169:24-171:14. The second was a "merger" between the two entities, the result of which would create a new public corporation without the need for an IPO. Schwimmer 12/8/06 Dep., 72:9-17. After discussing the advantages and disadvantages of each structure, Mr. Thain agreed to pursue structure two, the merger structure. Schwimmer Trial Testimony, 70:2-71:6.

Therefore, Mr. Thain was aware and was considering (as of

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[6] November 14, 2005, *Higgins v The New York Stock Exchange*, 10 Misc. 3d 257, (Sup Ct, NY County, 2005, J. Ramos).

January 24, 2005) an alternative transaction structure that could facilitate the NYSE to become a public entity without an initial public offering. This second (merger) structure was the same or similar structure that was subsequently executed between the two entities. Schwimmer Trial Testimony, 167:22-168:5. This discrepancy raises the issue of Mr. Thain's credibility, an issue best left to a trier of fact. See e.g. *Lapidus v New York City Chapter of New York State Asso. for Retarded Children, Inc.*, 118 AD2d 122, 129 (1st Dept 1986).

Furthermore, the facts alleged relative to actual falsity of Mr. Thain's statement are disputed. Defendants list a time-line of events contending that no reasonable jury could conclude that the NYSE had plans to go public as of February 15, 2005.

Plaintiff, however, alleges that even though the merger agreement was not yet signed between the NYSE and Archipelago at the time of Mr. Thain's statement, negotiations were well underway. For example, a framework for negotiation was accepted by the CEOs of both parties. Richard M. Phillips 11/17/2006 Dep. 169:1-13. The parties intended to move rapidly (one of the goals was to achieve a structure allowing the NYSE become a public entity as soon as possible. Schwimmer Trial Testimony, 170:3-7. The negotiations could lead to the NYSE becoming a public entity (after all appropriate approvals) "immediately." Schwimmer Trial Testimony, 171:18-172:8.

Therefore, defendants' contention that no reasonable jury could conclude that the NYSE had plans to go public as of the

date of Mr. Thain's statement is rejected.

Finally, there is no dispute as to whether plaintiff has been damaged. Rather, if successful in proving the liability of defendants, the measure of damages is disputed.[7]

Negligent Misrepresentation

Count two must be dismissed as a matter of law because Mr. Thain did not make the statement to plaintiff and he had no notice that Mr. Wey was acting on plaintiff's behalf.

The Court of Appeals has held that before a party may recover in tort for pecuniary loss sustained as a result of another's negligent misrepresentations there must be a showing of a special relationship, that being, actual privity of contract between the parties or a relationship so close as to approach that of privity. *Prudential Ins. Co. v Dewey Ballantine, Bushby, Palmer & Wood*, 80 NY2d 377 (1992), Reconsideration denied, 81 NY2d 955 (1993). The special relationship must be one of "trust or confidence, which creates a duty for one party to impart correct information to another." *Hudson River Club v Consolidated Edison Co. of New York, Inc.* 275 AD2d 218, 220 (1st Dept 2000). The special relationship requires a closer degree of trust than that in an ordinary business relationship. See *Dorsey Products Corp. v United States Rubber Co.*, 21 AD2d 866 (1st Dept 1964), affirmed 16 NY2d 925 (1965).

Further, if no actual privity exists (as neither party here

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[7] A detailed analysis of the measure of damages is discussed below with regard to defendants' motion in limine to preclude plaintiff's damages calculation.

contends), plaintiff must prove "(1) an awareness by the maker of the statement that it is to be used for a particular purpose; (2) reliance by a known party on the statement in furtherance of that purpose; and (3) some conduct by the maker of the statement linking it to the relying party and evincing its understanding of that reliance." *Parrott v Coopers & Lybrand, LLP*, 95 NY2d 479 (2000) [citing *Prudential Ins. Co. Of America v Dewey, Ballantine, Bushby, Plamer & Wood*, 80 NY2d 377, 384 (1992)].

Ms. Wey was not a "known party" to Mr. Thain at the time of the speaking. "[G]enerally, a negligent statement may be the basis for recovery of damages where there is carelessness in imparting words upon which others were expected to rely and upon which they did act or failed to act to their damage, but such information is not actionable unless expressed directly, with knowledge or notice that it will be acted upon, to one to whom the author is bound by some relation of duty, arising out of contract or otherwise, to act with care if he acts at all." *White v Guarente*, 43 NY2d 356, 363 (1977). *Emphasis supplied.* (Internal citations omitted).

Here, it is of no consequence if Mr. Thain "knew" that Mr. Wey was an owner of a seat because Mr. Wey is not the plaintiff. It is undisputed that Mr. Thain's statement was not "expressed directly" to plaintiff Ms. Wey and no evidence is provided that could impute knowledge to Mr. Thain that Mr. Wey was acting in an agency capacity for his wife. See e.g. *De Atucha v Mfg. Trust Co.*, 155 NYS2d 537 (*no official citation*)(Sup Ct, NY County,

1956), *aff'd*, 3 AD2d 902 (1st Dept)(a negligent misrepresentation claim by a third-party may proceed if an agency or representative relationship existed and the defendant had actual knowledge of it), appeal denied, 3 AD2d 1004, appeal denied, 3 NY2d 706 (1957). Plaintiff has failed to set forth any evidence to support such a jury determination, thus the second cause of action must be dismissed as a matter of law.

Breach of Fiduciary Duty

Defendants' motion for summary judgment dismissing the third cause of action for breach of fiduciary duty is denied because triable issues of material fact exist.

In the complaint, plaintiff alleges that Mr. Thain breached his fiduciary duty in making a false and/or materially misleading statement at the breakfast meeting on February 15, 2005.

A fiduciary relationship exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation. *EBC I, Inc. v Goldman Sachs & Co.*, 5 NY3d 11 (2005)(Emphasis supplied).

Defendants argue that Mr. Thain was not acting in the scope of the relationship with plaintiff as a seatholder because the breakfast meeting was a "private meeting with floor traders." However, the memo identified Mr. Wey as a "specialist and owner" and others as "floor members" or seatholders. Plaintiff asserts that Mr. Thain's alleged false statement was a breach of fiduciary duty to the "class of seatholders," giving rise to

plaintiff's individual cause of action (whether Mr. Wey had asked the question or not). This raises a disputed issue. That is, the purpose of the breakfast meetings. According to Mr. Thain and Mr. Tandy, the purpose of all the breakfast meetings was to:

> "have a dialogue with the people on the exchange who don't have an opportunity... to talk to me very often, to have them ask questions, express concerns etcetera." Thain 8/9/05 Dep., 12:7-12.
>
> "provide access from the various people on the floor who otherwise didn't typically have access to me, to ask questions to me, to make comments, the types of questions...ranged from the market structure to business strategy to ownership structure to seat values and lease rates..." Mr. Thain 8/9/05 Dep., 79:10-20.
>
> "update members in smaller groups...[because] the town hall meetings became very dominated by lessors, and it became very difficult for working members to get their questions answered..." Tandy 6/13/06 Dep. 116:23-117:4.
>
> "we were more focused on day-to-day, you know, what's it going to mean to me. So, John [Mr. Thain] agreed to do smaller group meetings to inform us better in terms of what his views were and what he thought...the future was going to look like." Tandy 6/13/06 Dep. 117:9-15.
>
> "anything was on the table... he was very good about allowing questions on any topic." Tandy Dep. 117:19-21.

Given these somewhat inconsistent viewpoints, the Court is unable to rule as a matter of law, whether Mr. Thain was acting in the scope of his relationship with seatholders while conducting these meetings. Thus, the claim stands and must be presented to a trier of fact.

If a jury determines that Mr. Thain was not acting in the scope of his relationship with seatholders, no fiduciary duty can be breached. However, if answered in the affirmative, the issue of "inaccurate, incomplete, or misleading prior disclosures"

becomes a central issue. See *Hyman v The New York Stock Exchange, et al.*, 2007 NY Misc. LEXIS 143 (Sup Ct, NY County 2007, J. Ramos).

Generally, there is no duty to disclose confidential business negotiations. However, in *Lindner Fund, Inc. v Waldbaum, Inc.* 82 NY2d 219, 223 (1993), the Court of Appeals noted that a special duty to disclose may arise in the case of insider trading, a statute or regulation requiring disclosure, or inaccurate, incomplete, or misleading prior disclosures. If a jury should determine that Mr. Thain's statement was incomplete or otherwise misleading, in accord with *Lindner*, a duty to immediately rectify the disclosure "springs into being." *Lindner*, 82 NY2d at 223.

Defendants contend that Mr. Thain's statement at the breakfast meeting was warranted because he was operating under a February 10, 2005 confidentiality agreement obligating him not to disclose the status of discussions concerning a potential transaction between the parties.

This Court does not agree. New York courts have recognized the need for confidentiality in merger negotiations to avoid speculative or premature market fluctuations. *Lindner*, 82 NY2d at 223. However, Mr. Thain's actions were arguably in contravention of the confidentiality agreement and *Lindner*. Confidentiality is the state of having the dissemination of certain information restricted. Blacks Law Dictionary, Seventh Edition, Page 294. This is achieved by refusing to speak on the

issue. Fact or fiction, Mr. Thain chose to speak at the breakfast meeting with regard to the future of the NYSE. As *Lindner* instructs, if a fiduciary chooses to disclose information to shareholders, it must be accurate, complete, and not misleading. *Lindner*, 82 NY2d at 223. This determination is a question for a jury. *See e.g. Curanovic v NY Cent. Mut. Fire Ins. Co.*, 307 AD2d 435 (3rd Dept 2003)(whether a statement is materially misleading is a question of fact that requires denial of...[a] motion for summary judgment). Thus, the motion is denied as to count three.

In Pari Delicto and Unclean Hands

Defendants contend the Weys' concerted effort to have Mr. Wey attend the breakfast meeting to solicit inside information from Mr. Thain and make a trade based on that disclosure, bars plaintiff from relief under principles of equity. See R. Wey 8/8/06 Dep. 106:5-8; 195:9-25; 105:22-106:8; A. Wey 9/12/06 Dep. 244:18-245:3; 247:10-248:11; 477:20-479:21.

To this end, defendants raise two related equitable defenses. *In pari delicto* which literally means "in equal fault," and *unclean hands*, which stands for the proposition that a plaintiff may not profit from her own wrongdoing. *Riggs v Palmer*, 115 NY 506 (1889); *Reno v D'Javid*, 55 AD2d 876 (1st Dept, affirmed, 42 NY2d 1040 (1977). First, unclean hands is an equitable defense that is unavailable in an action exclusively for damages. *Manshion Joho Ctr. Co., Ltd. v Manshion Joho Ctr., Inc.*, 24 AD3d 189 (1st Dept 2005)[citing *Hasbro Bradley, Inc. v Coopers &*

Lybrand, 128 AD2d 218 (1st Dept 1987)]. This is an action at law; thus, unclean hands is inapplicable to this case.

The defense of *in pari delicto* is grounded on two premises: (1) courts should not lend their good offices to mediating disputes among wrongdoers; and (2) denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality. *Bateman Eichler, Hill Richards, Inc. v Berner*, 472 US 299 (1985). *In pari delicto* requires immoral or unconscionable conduct that makes the wrongdoing of the party against which it is asserted at least equal to that of the party asserting it. *Chemical Bank v Stahl*, 237 AD2d 231 (1st Dept 1997).

The *in pari delicto* defense is used sparingly. *Alami v Volkswagen of America, Inc.*, 97 NY2d 281, 287-8 (2002). See *Perma Life Mufflers, Inc. v International Parts Corp.*, 392 US 134 (1968)(not recognizing *in pari delicto* defense in Clayton Antitrust action). The Weys' alleged wrongdoing was an attempt to trade using insider information, possibly a criminal violation of federal and state securities laws. *Dirks v SEC*, 463 US 646 (1983); *People v Napolitano*, 282 AD2d 49 (1st Dept 2001), appeal denied, 96 NY2d 866 (2001). Accordingly, we can look to federal securities litigation for guidance. See *Ross v Bolton*, 904 F2d 819 (2d Cir 1990)(recognizing defense in securities cases). To ensure that the defense is narrowly applied in such cases, the Supreme Court in *Bateman Eichler, Hill Richards, Inc. v Berner supra*, set forth a two-part test for the application of the defense in private causes of action under securities laws.

Bateman Eichler, 472 US at 310-11. The Court noted that the doctrine may bar an action "where (1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public." Id.

The first prong of the test sets forth the essential elements of the doctrine. See *Pinter v Dahl*, 486 US 622 (1988). Courts apply the defense where the plaintiff has participated in some of "the same sort of wrongdoing" as the defendant. *Bateman Eichler*, 472 US at 307.

> "A defendant cannot escape liability unless, as a direct result of the plaintiff's own actions, the plaintiff bears at least substantially equal responsibility for the underlying illegality. The plaintiff must be an active, voluntary participant in the unlawful activity that is the subject of the suit..." *Pinter*, 486 US at 636.

The process of weighing these faults is the function of the jury. See *Banks v Central Hudson Gas & Electric Corp.*, 224 F2d 631 (2d Cir, cert denied, 350 US 904 (1955).

The second prong, which considers public policy implications of applying the defense, is consequential of the first. As the Supreme Court noted in *Pinter*, refusal of relief to those less blameworthy would frustrate the purpose of the securities laws; it would not serve to discourage the actions of those most responsible for organizing forbidden schemes; and it would sacrifice protection of the general investing public in pursuit

of individual punishment. *Pinter*, 486 US at 636.

The Court queries whether this defense, as applied to the facts here, is dispositive of the action. Assuming for the purpose of this motion only Mr. Thain's alleged wrongful conduct, if no reasonable jury could conclude that Mr. Thain's alleged misrepresentation and breach of fiduciary duty is substantially equal to or outweighs plaintiff's wrongful conduct of seeking insider information from Mr. Thain, a possible violation of criminal law, then the action must be dismissed. The question is whether plaintiff actually attempted to violate the federal insider trading law or any other law and if so whether, as a matter of law, that would overwhelm any bad act by Mr. Thain. *People v Napolitano, supra; Country-Wide Home Loans, Inc. v LaFonte*, No. 14265/01, 2003 WL 1389089, at *3 (Sup Ct, Nassau County 2003); *Drexel Burnham Lambert Group, Inc. v Vigilant Ins. Co.*, 157 Misc 2d 198, 212-214 (Sup Ct, NY County 1993). For example, was Mr. Thain or Mr. Wey a tipper, and if so, what are the consequences? *Dirks v SEC*, 463 US 646 (1983); *People v Napolitano, supra*. Even, if Wey's act was not criminal, *in pari delicto* could still apply. *See also, Smith v Jay Apartments, Inc.*, 33 AD2d 624 (3d Dept 1969)(negligent landlord's complaint against elevator company dismissed because landlord was *in pari delicto* for knowing about condition of elevator but failing to warn tenants), appeal denied, 26 NY2d 609 (1970). Therefore, the parties are instructed to brief the issue within thirty days after service of this order with notice of entry. The parties

are to simultaneously exchange briefs solely addressing the *in pari delicto* defense. Replies shall be exchanged thirty days thereafter. The parties shall deliver copies of their briefs to the Court's part clerk, Room 238 and call the part clerk to schedule a mutually agreeable date and time for argument.

Claims Against the NYSE

Plaintiff alleges that the NYSE is vicariously liable for Mr. Thain's alleged wrongful acts. The NYSE motion to dismiss the breach of fiduciary duty claim is granted as a corporation, even a non-profit organization, has no fiduciary duty to its shareholders, or seatholders in this case. See *Gates v BEA Assoc., Inc.*, NO. 88 Civ. 6522, 1990 WL 180137, at *6 1990 US Dist Lexis 15299 (SDNY 1990). Having dismissed the negligent misrepresentation claim, the only remaining claim against the NYSE is vicarious liability for Thain's alleged misrepresentation.

Damages

In the complaint, plaintiff seeks unspecified damages. In a New York Post article, Mr. Krum was quoted as saying that Ms. Wey would be seeking damages of "'at least $1 million,' plus other, unspecified damages." In the note of issue, dated December 13, 2006, plaintiff demands $4,384,561.

There is no dispute that if plaintiff establishes liability, she is entitled to damages. The issue is what constitutes the proper measurement of damages?

> The true measure of damage is indemnity for the actual pecuniary loss sustained as the direct result of the

> wrong" or what is known as the "out-of-pocket" rule [citation omitted]. Under this rule, the loss is computed by ascertaining the "difference between the value of the bargain which a plaintiff was induced by fraud to make and the amount or value of the consideration exacted as the price of the bargain" [citation omitted]. Damages are to be calculated to compensate plaintiffs for what they lost because of the fraud, not to compensate them for what they might have gained. [citation omitted]. Under the out-of-pocket rule, there can be no recovery of profits which would have been realized in the absence of fraud [citations omitted].

Lama Holding Co. v Smith Barney Inc., 88 NY2d 413, 421 (1996). Plaintiff challenges the applicability of Lama Holdings to this case. Lama Holding Co. owned 24% of the shares of Smith Barney and had a right of first refusal on any merger with Smith Barney, pursuant to a complex tax structure in the United States Tax Code, known as the General Utilities Doctrine, which allowed a domestic company to sell its assets without incurring tax liability. *Id.* at 419-420. When Smith Barney agreed to sell all of its stock to Primerica, Smith Barney met with Lama to induce it to agree to the merger immediately without the advice of legal or financial counsel. *Id.* at 419. Unbeknownst to Lama, months earlier, Congress had changed the Tax Code repealing the General Utilities Doctrine. Lama contended it was fraudulently induced to agree to the merger which resulted in a tax liability to Lama of $33 million. *Id.* at 420. Lama alleged fraud based on Smith Barney's failure to disclose that Primerica could withdraw from the merger if 5% of common stockholders did not approve the transaction nor the tax consequences of the sale. *Id.* In other words, with 24% of the shares, and had it known, Lama could have

stopped the merger. Lama attempted to negotiate a separate purchase transaction with Primerica, but it refused. *Id.* The court held that Lama could not measure its damages based on Lama's proposed deal with Primerica as it was speculative. *Id.* at 422.

Plaintiff argues that the *Lama* case is inapplicable here as Ms. Wey's alternative contractual bargain was concrete and embodied in the merger terms offered to the seatholders. However, this is not a breach of contract action, but a fraud case and thus *Lama* clearly applies. Here, the undisclosed deal, to merge with Archipelago, closed, just as the undisclosed deal in Lama, Smith Barney with Primerica, closed. Plaintiff cannot in hindsight compare the certainty of the merger here with the uncertainty of the deal Lama proposed to Primerica. Likewise, in hindsight, plaintiff proposes that the merger terms are concrete. But until the deal closed on March 7, 2006, there was always a risk that the merger would not occur and the market price of seats would reflect that risk.

Defendants' motion is granted as plaintiff's proposed measure of damages is too speculative. While lost profits are recoverable in both fraud and contract actions, in either case they "may not be merely speculative, possible or imaginary, but must be reasonably certain and directly traceable to the breach, not remote or the result of other intervening causes." *Kenford Co. v County of Erie*, 67 NY2d 257, 261 (1986). Where contract damages are limited to those reasonably contemplated by the

parties, for fraud, the loss must naturally follow the wrongful act. *Schile v Brokhahus*, 80 NY 614, 620 (1880). Reasonable certainty is always required. *Delehanty v Walzer*, 59 NYS2d 777 (Sup Ct, Kings County 1945)(no official citation), *judgment rev'd on other grounds*, 271 AD 886, (2d Dept 1946), *judgment aff'd*, 298 NY 820 (1949). Multiple assumptions will doom a projection. *Kenford* at 262. Here, plaintiff assumes the following: (1) she would not have sold after the merger announcement; (2) she would have received annual lease income of $200,000 even though her actual lease income was $83,000 in 2005; (3) she would have elected the maximum cash payments between 2006 and 2009; (4) the NYSE stock price can be projected for March 2008 and March 2009. Depending on plaintiff's expert's underlying assumptions, plaintiff's estimated damages vary by as much as $3 million. These multiple assumptions doom reasonable certainty.

The measure of damages for items of fluctuating value such as marketable securities will be the difference between the proceeds received and the highest market value within a reasonable time after notice of the fraud. *Gelb v Zimet Brothers, Inc.*, 34 Misc 2d 401, 402 (Sup Ct, NY County 1962), aff'd, 18 AD2d 967 (1st Dept 1963). The purpose of the reasonable time rule is to give plaintiff time to make decisions such as whether to repurchase securities. *Phillips v Bank of Athens Trust Co.*, 202 Misc 698, 702 (Sup Ct, NY County 1952).

What is a reasonable period of time? The period has ranged from one to four weeks after learning of the alleged fraud

depending on the circumstances of the case. *Mitchell v Texas Gulf Sulphur Co.*, 446 F.2d 90, 105 (10th Cir 1071)(9 days after date on which a diligent and reasonable investor would have been informed of April 16, corrected press release), cert denied, 404 US 1004 (1971); *Phillips, supra* at 703 (7 days after plaintiff notified defendant of his objections to the sale of his securities. "[Plaintiff's] delay and decision to do nothing was occasioned by his determination to speculate on the continued rise of the market. Such speculation at the expense of the defendant cannot be condoned by the court."); *Newman v Smith*, 1975 WL 389 at *4, 1975 U.S. Dist. LEXIS 12686, Fed. Sec. L. Rep. (CCH) P95,078 (SDNY 1975)(17 days after notice of unauthorized sale of stock); *Halifax Fund LP v MRV Communications Inc.*, No. 00 CIV 4878 HB, 2001 WL 1622261, 2001 U.S. Dist. LEXIS 20933 (SDNY 2001)(3 weeks from notice of unauthorized sale to cover), affm'd, 54 Fed. Appx. 718, 2003 U.S. App. LEXIS 78 (2d Cir. 2003). Plaintiff's projection to 2009 is too far into the future, far too speculative, and not reasonable.

Plaintiff challenges whether the market price is an accurate reflection of value since the market for seats on the NYSE was small and inefficient. Plaintiff relies on the NYSE's acting Chairman's announcement on November 9, 2005 that the "imputed value" of NYSE seats was $4.5 million when the seats were trading for $3 million. Plaintiff also relies on *Scalp & Blade, Inc. v Advest Inc.*, 309 AD2d 219 (4th Dept 2003) for the proposition that this Court may not limit plaintiff's proof of damages on a

motion in limine.

In *Scalp & Blade*, a churning case, the lower court limited damages to the difference in value from the beginning of defendants control of the account and when defendants were removed from control of the account. Id. The Appellate Division reversed holding that plaintiffs could measure damages using a market index such as the S&P 500 to adjust for gains which may have occurred if the defendant had not been churning the account. Id. However, the time period remained the same.

This Court rejects plaintiff's procedural argument that defendants' motion is a disguised motion for summary judgment. Rather, a motion in limine is the appropriate vehicle to determine what evidence may be presented at trial regarding damages. *State v Metz*, 241 AD2d 192, 198 (1st Dept 1998).

This case also differs from *Scalp & Blade* in one significant way; in a churning case, the time period during which the market index is applied is fixed as the time during which defendant was in control of the account and churning it. Here, the time period for the calculation of damages is not fixed. Accordingly, the legal authority on this issue holds that a reasonable time is to be used.

Plaintiff's damages should be measured by the reaction of the market for NYSE seats within a reasonable time after the merger announcement. *Affiliated Ute Citizens of the State of Utah v United States*, 406 US 128, 155 (plaintiffs should be awarded, not the future value of their investments if they had

decided not to sell them at all, but the difference between what they actually received and the fair value of their investment at the time of their sale), rehearing denied 407 US 916 (1972). *See also Gelb, supra.* Assuming the parties cannot agree to a reasonable period, it will be determined by the jury. The parties are welcome to offer experts to testify why one value or time period is more accurate than another. "[I]nferences may be drawn from surrounding circumstances as to the period of time which is reasonable for the ascertainment of damages." *Phillips v Bank of Athens Trust Co.*, 202 Misc 698, 702 (Sup Ct, NY County 1952). However, the time period will be a reasonable one and in no case shall it extend beyond 60 days from the announcement. In 60 days or less, plaintiff would have had sufficient time to decide whether to re-purchase a seat and seek financing if necessary. Further, as in *Scalp & Blade*, plaintiff may convince the jury that the market price, within the 60 day period after the merger announcement, was not an accurate reflection of a seat's value and thus that a multiple should be applied to the market price.

Therefore, defendants' motion is granted.

Motion for Preliminary Injunction

The trial of this action was scheduled to begin on January 31, 2007.

On January 18, 2007, Mr. Krum was quoted in an article in the ew York Post entitled "Traders Back Suit, Claim Thain Misled." The article was accompanied by a picture of Mr. Wey in

front of the New York Stock Exchange. The reporter states in the article that he reviewed a document with Mr. Thain's schedule and notes. We now know that document referred to in the article is plaintiff's Exhibit 39, "Floor Member Breakfast Meeting: 8:00 am-Room 630: Tuesday, February 15, 2005," bearing Bates number W000266 or W00002. It is not contradicted that defendants had marked it "confidential" pursuant to this Court's approved confidentiality agreement. At the argument on the motion on January 29, 2007, Mr. Krum admitted his mistake in showing the confidential document to the reporter.

Mr. Thain argues that Mr. Krum violated the disciplinary rules by speaking to the press and giving the reporter a confidential document. DR 7-107, 22 NYCRR 1200.38 provides:

> (a) A lawyer participating in or associated with a criminal or civil matter, or associated in a law firm or government agency with a lawyer participating in or associated with a criminal or civil matter, shall not make an extrajudicial statement that a reasonable person would expect to be disseminated by means of public communication if the lawyer knows or reasonably should know that it will have a substantial likelihood of materially prejudicing an adjudicative proceeding in that matter. Notwithstanding the foregoing, a lawyer may make a statement that a reasonable lawyer would believe is required to protect a client from the substantial prejudicial effect of recent publicity not initiated by the lawyer or the lawyer's client. A statement so made shall be limited to such information as is necessary to mitigate the recent adverse publicity.(b) A statement ordinarily is likely to prejudice materially an adjudicative proceeding when it refers to a civil matter triable to a jury, a criminal matter, or any other proceeding that could result in incarceration, and the statement relates to:(1) The character, credibility, reputation or criminal record of a party, suspect in a criminal investigation or witness, or the identity of a witness, or the expected testimony of a party or witness.

Defendants argue that disclosure of the document was a violation of the confidentiality agreement executed on February 24, 2006.

Mr. Krum submitted an affidavit in opposition setting forth his pedigree, but not addressing the motion. At argument, he explained on the record that he spoke to the NY Post reporter who had called him after receiving from the New York Stock Exchange by e-mail on January 17, 2007 a copy of the NYSE brief on its motion for summary judgment, which had been served on plaintiff on January 12, 2007, as well as filed in the court. Mr. Krum read to the court his response to the reporter which was: "It is my opinion that when the trial starts in two weeks, the evidence that the plaintiff offers will establish that the head of the New York Stock Exchange refuses to accept responsibility for his actions and continues to cover up his own false statements and misleading half truths."

As a consequence, this Court adjourned the trial of this matter until September 12, 2007 to ensure that the article would not prejudice the parties at trial. The parties were also directed to forego gratuitous remarks to the press, though remarks consistent with DR 7-107 would be allowed.

The remaining question is whether any further steps need be taken to protect this proceeding from the effects of the article or disclosure of a confidential document and whether there has been a violation of the disciplinary rules.

> "Trial courts have 'broad power to regulate discovery to prevent abuse' [citation omitted]. 'When the

> disclosure process is used to harass or unduly burden a party, a protective order eliminating that abuse is necessary and proper' [citation omitted]. Courts are empowered to limit press and public access to court proceedings to maintain order and decorum and to protect the rights of parties and witnesses."

In Nicholson v Luce, NYLJ, Nov. 9, 2006, at 22 (Sup Ct, NY County 2006), the court sanctioned an attorney under DR 7-107 for his statements to the press. The attorney commented on plaintiff's claims and the probative value of a letter disclosed at a deposition. He also disseminated the deposition transcript to the press. The sanction included: (1) enjoining the public disclosure and dissemination of any discovery material that is not required to be filed with the court; (2) enjoining the attorney from further violation of DR 7-107; and (3) imposing the cost of bringing the application for relief from the violative statements and actions, including attorneys' fees.

Here, it appears that the NYSE, not Mr. Thain, sent its summary judgment brief to the NY Post. When the NY Post called Mr. Krum for comment, he did not respond to the brief, but made a gratuitous statement concerning Mr. Thain. Admittedly, Mr. Krum showed a confidential document to the NY Post reporter. It does not appear that a copy of the confidential document was given to the reporter. If it was, then Mr. Krum is directed to retrieve it immediately. Otherwise, there appears to be no need for further action as the delay of the trial and prohibition against further unnecessary statements squarely deals with the problem of influencing the jury pool.

Accordingly, it is

ORDERED that defendants' motion for summary judgment dismissing the complaint as to count two is granted and negligent misrepresentation is dismissed; and it is further

ORDERED, that the motion to dismiss the fraud and breach of fiduciary duty claims is denied except that the motion is held in abeyance as to the *in pari delicto* defense. The parties are instructed to brief the issue within thirty days after service of this order with notice of entry. The parties are to simultaneously exchange briefs solely addressing the *in pari delicto* defense. Replies shall be exchanged thirty days thereafter. The parties shall deliver copies of their briefs to the Court's part clerk, Room 238 and call the part clerk to schedule a mutually agreeable date and time for argument; and it is further

ORDERED, that the claims for breach of fiduciary duty and negligent misrepresentation are dismissed against the NYSE; and it is further

ORDERED, that defendants' motion 03 to limit plaintiff's damages evidence at trial is granted; and it is further

ORDERED, that defendants' motion 05 is granted to the extent that the trial is adjourned to September 12, 2007 and Mr. Krum is directed to retrieve the confidential document from the NY Post reporter if it was given to the reporter. All parties are directed to comply with all disciplinary rules. In particular, the parties shall comply with DR 7-107.

Dated: April 10, 2007

J.S.C.

CHARLES E. RAMOS

Counsel are hereby directed to obtain an accurate copy of this Court's opinion from the record room and not to rely on decisions obtained from the internet which have been altered in the scanning process.

EXHIBIT 6

ginsburgruling

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

CHUCK GINSBURG, Plaintiff,	:	
vs.	:	Civil Action No. 2202-N
PHILADELPHIA STOCK EXCHANGE, INC., et al., Defendants.	:	

- - -

Via telephone
New Castle County Courthouse
Wilmington, Delaware
Thursday, December 7, 2006
2:30 p.m.

- - -

BEFORE: HON. WILLIAM B. CHANDLER, III, Chancellor.

- - -

COURT'S RULING ON MOTIONS TO DISMISS

- - -

CHANCERY COURT REPORTERS
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* * *

THE COURT: Thank you, Mr. Lockwood. As I said, it wasn't material to today.

If there is nothing further in the way of argument from counsel, I want to go ahead and tell you how I'm going to rule in the case. I do that because, number one, the motions have been pending for quite some time. In addition, I denied expedited relief earlier this summer, and some period of time has elapsed. Therefore, I think it's prudent to go ahead and give you the benefit of my thoughts today about how these motions should be resolved.

I do that with some hesitancy, because I'm not going to come close to being as skillful and eloquent as counsel have been, both on the conference

call today and in your very thoughtful and careful briefs that you submitted to the Court. So with some trepidation in that sense, I'm going to provide you with my thinking about the pending motions.

But before I do that, I want to pause to thank you and everyone else who is on the line for being available for the oral arguments via this conference call, which was arranged at my insistence and at my request because of scheduling difficulties

that, personally, I am confronted by. Otherwise, I would have been, as you all know, very happy to entertain everyone, including Mr. Deutsch's clients, coming down from Philadelphia to visit Georgetown. I'm sorry I could not accommodate everyone, but I do appreciate your willingness to provide the oral arguments and this hearing today by telephone, despite the glitches that have arisen from time to time.

First of all, let me take a moment to restate the issue that I think lies at the heart of this case. Has the plaintiff made sufficient allegations under the standard of Rule 12(b)(6) that I may reasonably infer that the strategic investor defendants worked together with each other and with the Exchange defendants in order to arrange the sale of control of the Philadelphia Stock Exchange? The question is not the focus of this motion or motions to dismiss, of course.

The motions, and the accompanying briefs, make two principal arguments: First, that plaintiff's claim is derivative, not direct, and that

plaintiff has thus failed the test for demand excusal under Chancery Court Rule 23.1; and second, that even if the claim is direct, the Exchange defendants are

protected by the business judgment rule. As a corollary, of course, if I cannot find adequate allegations that the Exchange defendants breached a fiduciary duty, then there can be no aiding and abetting claim against the strategic investor defendants.

But, as I will explain, the determinative issue on each of these questions is really the nature of the negotiations between the board and the strategic investors. For instance, giving the plaintiff the benefit of every reasonable inference that can be drawn from the complaint, a complaint that admittedly is somewhat confused, I nonetheless find that the plaintiff states a direct claim, because he alleges a harm that is specific to his class of shares, and because there are remedies which this Court might grant that will benefit the Class A shareholders, rather than the corporation itself.

A distinct harm to the plaintiff class and a distinct remedy are, of course, the two factors required of a direct claim under the tests articulated by the Delaware Supreme Court in Tooley v. Donaldson, Lufkin & Jenrette.

Now, the defendants trumpet my decision in Paxson, citing it for the proposition that

a direct claim for dilution may only be asserted when a significant stockholder's interest is increased at the sole expense of the minority. And that statement is true for the facts of Paxson or in cases where shareholders are diluted in a series of truly independent transactions occurring in the marketplace. This case differs from Paxson, however, in the nature of the fiduciary duty allegedly breached.

According to paragraph 62 of the complaint, Class A shareholders negotiated during the demutualization process the right to be free of excessive concentrations of control either by individual shareholders or related persons. Such persons are defined in the restated certificate of incorporation as any two or more persons that have any agreement, arrangement or understanding, whether or not in writing, to act together for the purpose of acquiring, holding, voting or disposing of shares of common stock.

To my mind, the word "acquiring" is critical. The board was arguably under a fiduciary obligation to prevent a sale of more than 20 percent

of the shares of the company to related persons. The protection afforded by Article 4 of the certificate is a right of the shareholders individually, not the company. If the strategic investors made their purchases in less than individual, arm's-length investments, such that they would be related persons, and the board recommended such an action, the fiduciary duty claim would appear to stem from a

breach of Article 4. That, at this point, is the theory, at least. Whether the facts will bear it out, of course, is an issue for another day.

Second, there is a reasonable basis to infer at this preliminary stage that the strategic investors did collaborate with the board and with each other. The complaint alleges that plaintiffs were diluted in two separate transactions, the Citadel and Merrill Lynch transaction, announced June 16, 2005, and the transactions with the four other strategic investors, announced two months later. The complaint also alleges in paragraphs 108 to 116 that despite the fact that the Exchange defendants' advisors adopted different numbers and differing valuations, all six strategic investors purchased their shares on very similar terms. Paragraphs 121 through 123 of the

complaint, then, allege that this was no mere accident, but part of the board's strategic plan.

It is possible, of course, that the board had determined a price at which to offer the strategic investors the opportunity to invest, that every single negotiation was held independently, at arm's length, with each strategic investor, and that the stars and planets just happened to align such that Merrill Lynch and Morgan Stanley both settled on a price of $7.5 million for the same investment, based upon two differing sets of assumptions, made two months apart.

The defendants will of course attempt to show this at summary judgment or at trial, but at

this preliminary stage, where every reasonable inference must be made in favor of the plaintiff, and where the plaintiff has not had the full benefit of discovery, it would be utterly unreasonable for me to infer, based on the allegations in the complaint, that the strategic investors were working independently.

Because the complaint alleges that the Class A shareholders were denied their contractual rights, the complaint states a direct claim, and the Exchange defendants' arguments regarding demand are,

thus, irrelevant. The only remaining issue, then, is whether the facts alleged state a claim for which relief may be granted.

Turning, then, to the second question, a reasonable inference of collaboration by the strategic investors and the Exchange defendants also avoids the necessity to discuss whether the board's actions implicate the rule of Revlon and its progeny. As the Delaware Supreme Court noted in Sanders v. Wang, albeit in the context of demand, where board actions are alleged to violate a legitimate agreement reached by shareholders, it by necessity raises doubt as to whether the board's actions are the result of good business judgment and deserve protection of the business judgment rule.

Finally, I see no insuperable impediment to crafting relief that would benefit the plaintiff class. On the one hand, there is the drastic remedy of rescission of the strategic investors' purchases, which does still seem to me to

be practically available, or the less drastic remedy of invalidating the warrants issued to each party. It strikes me, on the other hand, that the simple declaration that the strategic investors qualify as

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related persons under the terms of the company's certificate might supply adequate alternative relief. At that point, the strategic investors would be enjoined from voting, collectively, more than 20 percent of the shares outstanding, until all shareholders decide to remove the restrictions of Article 4, assuming that is legally possible. This would also allow the Class A shareholders to negotiate effectively for any control premium to which they might be entitled.

Let me emphasize, however, that I mention this not to predict any eventual decision on the merits, but simply to underscore my determination that this is a direct, not a derivative, claim.

For these reasons, I deny both the Exchange defendants' and the strategic investor defendants' motion to dismiss. If there is nothing else that I can help either party with today, I will end with a request that counsel promptly discuss and agree upon a scheduling order that will establish a prompt discovery exchange period, followed by either a summary judgment briefing schedule or a trial date, a trial that I would expect and hope to occur no later than late spring or early summer of 2007.

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To the extent that an order is necessary to implement this ruling, it is so ordered. I appreciate your availability, counsel. Court is adjourned.

MR. DEUTSCH: Thank you, Your Honor.

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CERTIFICATE

I, WILLIAM J. DAWSON, Official Court Reporter of the Chancery Court, State of Delaware, do hereby certify that the foregoing pages numbered 3 through 12 contain a true and correct transcription of the proceedings as stenographically reported by me at the

hearing in the above cause before the Chancellor of the State of Delaware, on the date therein indicated. The ruling was edited by the Chancellor subsequent to the hearing.

IN WITNESS WHEREOF I have hereunto set my hand at Wilmington, this 8th day of December, 2006.

Official Court Reporter
of the Chancery Court
State of Delaware

Certification Number: 187-PS
Expiration: Permanent

EXHIBIT 7

EXHIBIT 7

CONFIDENTIAL:
FILED UNDER SEAL

EXHIBIT 8

EXHIBIT 8

CONFIDENTIAL:
FILED UNDER SEAL

EXHIBIT 9

EXHIBIT 9

CONFIDENTIAL:
FILED UNDER SEAL

EXHIBIT 10

EXHIBIT 10

CONFIDENTIAL: FILED UNDER SEAL