

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-56145; File No. SR-NASD-2007-023)

July 26, 2007

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc.

I. Introduction

On March 19, 2007, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“Commission” or “SEC”) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend the By-Laws of NASD (“NASD By-Laws”) to implement governance and related changes to accommodate the consolidation of the member firm regulatory functions of NASD and NYSE Regulation, Inc. (“NYSE Regulation”), a wholly-owned subsidiary of New York Stock Exchange LLC (“NYSE LLC”). The proposed rule change was published for comment in the Federal Register on March 26, 2007.<sup>3</sup> The Commission received 80 comment letters from 72 commenters on the proposed rule change.<sup>4</sup>

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

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

<sup>3</sup> See Securities Exchange Act Release No. 55495 (March 20, 2007), 72 FR 14149 (“Notice”).

<sup>4</sup> A list of commenters on the rule proposal, whose comments were received as of July 16, 2007, is attached as Exhibit A to this Order. The public file for the proposal, which includes comment letters received on the proposal, is located at the Commission’s Public Reference Room located at 100 F Street, NE, Washington, DC 20549. The comment letters are also available on the Commission’s Internet Web site (<http://www.sec.gov/rules/sro.shtml>).

The NASD filed a response to comments on May 29, 2007 and a supplemental response to comments on July 16, 2007.<sup>5</sup> This order approves the proposed rule change.

## II. Description of the Proposed Rule Change

In November 2006, NASD and NYSE Group, Inc. (“NYSE Group”)<sup>6</sup> announced their plan to consolidate their member regulation operations into a single self-regulatory organization

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<sup>5</sup> See Letter from Patrice M. Gliniecki, Senior Vice President and Deputy General Counsel, NASD, to Nancy M. Morris, Secretary, Commission, dated May 29, 2007 (“NASD Response Letter”) and Letter from T. Grant Callery, Executive Vice President and General Counsel, NASD, to Nancy M. Morris, Secretary, Commission, dated July 16, 2007 (“NASD Supplemental Response Letter”). NASD Dispute Resolution also filed two letters in response to comments. See Letter from Linda D. Fienberg, President, NASD Dispute Resolution, to the Public Members of SICA, dated January 26, 2007 (“NASD Dispute Resolution Letter I”) and Letter from Linda D. Fienberg, President, NASD Dispute Resolution, to Nancy M. Morris, Secretary, Commission, dated May 29, 2007 (“NASD Dispute Resolution Letter II”). NASD submitted an opinion of counsel regarding the approval by NASD members of proposed amendments to the NASD By-Laws and the amount of the payment to NASD members under Delaware Law. See Letter from William J. Haubert, Richards, Layton & Finger, to Nancy M. Morris, Secretary, Commission, dated July 16, 2007 (“RLF Letter”). NASD also submitted an opinion of counsel describing generally the case law, statutory provisions, and guidance published by the Internal Revenue Service (“IRS”) relevant to the disclosure in the NASD’s proxy statement to members. See Letter from Mario J. Verdolini, Davis Polk & Wardwell, to Nancy M. Morris, Secretary, Commission, dated July 16, 2007 (“DPW Letter”).

<sup>6</sup> NYSE Group recently combined with Euronext N.V. (“Euronext”) to form a single, publicly traded holding company named “NYSE Euronext.” NYSE Group and Euronext became separate subsidiaries of NYSE Euronext. The corporate structure for the businesses of NYSE Group (including the businesses of the NYSE LLC and NYSE Arca, Inc., a registered national securities exchange) remained unchanged following the combination. Specifically, NYSE LLC remains a wholly-owned subsidiary of NYSE Group. NYSE Market remains a wholly-owned subsidiary of the NYSE LLC and conducts NYSE LLC’s business. NYSE Regulation remains a wholly-owned subsidiary of NYSE LLC and performs the regulatory responsibilities for NYSE LLC pursuant to a delegation agreement with NYSE LLC and many of the regulatory functions of NYSE Arca pursuant to a regulatory services agreement with NYSE Arca. See Securities Exchange Act Release No. 55293 (February 14, 2007), 72 FR 8033 (February 22, 2007). Commenters on the proposed rule change generally referred to NYSE Group as “NYSE.”

(“SRO”) that would provide member firm regulation for securities firms that do business with the public in the United States (“Transaction”). Pursuant to the Transaction, the member firm regulation and enforcement functions and employees from NYSE Regulation would be transferred to NASD, and NASD would adopt a new corporate name. In the proposed rule change, the NASD proposes to amend the NASD By-Laws to implement governance changes that are integral to the Transaction. The proposed rule change and this Order refer to the NASD, whose name would be changed to the Financial Industry Regulatory Authority, as the “New SRO” and the amended NASD By-Laws as the “New SRO By-Laws.”

The New SRO would 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 The NASDAQ Stock Market, Inc., the American Stock Exchange LLC, and the International Securities Exchange, LLC; and industry utilities, such as Trade Reporting Facilities and other over-the-counter operations. NASD represents that none of NASD’s current functions and activities would be eliminated as a result of the Transaction.

The closing of the Transaction (“Closing”) and the consolidation of the member firm regulatory functions of the NASD and NYSE Regulation are subject to the execution of definitive agreements between NASD and NYSE Group, the Commission’s approval of the proposed rule change, and certain additional regulatory approvals.<sup>7</sup> The effective date of the

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<sup>7</sup> On March 7, 2007, NASD and NYSE Group filed notification reports with the Department of Justice and the Federal Trade Commission under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. NASD represented that the waiting period for such a filing expired on April 6, 2007. NASD also represented that it received a favorable ruling by the IRS that the Transaction would not affect the tax-exempt status of NASD or NASD Regulation. See NASD Supplemental Response Letter, supra note 5, at 3.

proposed rule change would be the date of the Closing. There would be a transitional period commencing on the date of the Closing and ending on the third anniversary of the date of the Closing (“Transitional Period”).

A description of the most significant changes to the NASD By-Laws follows.

A. Composition of the New SRO Board

The proposed rule change would implement a governance structure that includes both public and industry representation, and designates certain Governor<sup>8</sup> positions on the New SRO Board of Governors (“New SRO Board”) to represent member firms. Members would not have the ability to elect all Governors of the New SRO Board, but would have the ability to elect Governors that are from member firms that are similar in size to their own firms. All other Governors would be appointed, as described below. All members would continue to have the ability to vote on any future amendments to the New SRO By-Laws,<sup>9</sup> to petition to propose amendments to the New SRO By-Laws,<sup>10</sup> to vote in district elections,<sup>11</sup> and to petition to nominate a candidate for the Governor position(s) they are entitled to elect.<sup>12</sup>

1. Composition of New SRO Board during the Transitional Period

During the Transitional Period, the New SRO Board would consist of 23 Governors as follows: (a) eleven Governors would be “Public Governors;”<sup>13</sup> (b) ten Governors would be

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<sup>8</sup> A “Governor” is a member of the Board of Governors of the New SRO. See New SRO By-Laws, Article I(q).

<sup>9</sup> See New SRO By-Laws, Article XVI, Section 1.

<sup>10</sup> Id.

<sup>11</sup> See Article VIII of the NASD Regulation, Inc. By-Laws (“NASD Regulation By-Laws”).

<sup>12</sup> See New SRO By-Laws, Article VII, Section 10.

<sup>13</sup> A “Public Governor” means any Governor who is not the Chief Executive Officer of the New SRO or, during the Transitional Period, the CEO of NYSE Regulation, who is not

“Industry Governors”;<sup>14</sup> and (c) two Governors initially would be Richard G. Ketchum, currently Chief Executive Officer (“CEO”) of NYSE Regulation and Mary L. Schapiro, currently CEO of NASD. Mr. Ketchum would serve as Chair of the New SRO Board (“Chair”)<sup>15</sup> for a term of three years.<sup>16</sup> Ms. Schapiro would serve as CEO of the New SRO.

Initially, five Public Governors would be appointed by the Board of Directors of NYSE Group (“NYSE Group Board”); five Public Governors would be appointed by the NASD Board of Governors in office prior to the Closing (“NASD Board”); and one Public Governor would be appointed jointly by the NYSE Group Board and the NASD Board (the “Joint Public Governor”). A Public Governor must not have any material business relationship with a broker or dealer or an SRO registered under the Exchange Act (other than serving as a public director of such an SRO).<sup>17</sup>

The ten Industry Governors would consist of: (a) three Governors who are registered with members that employ 500 or more registered persons (“Large Firm Governors”); (b) one

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an Industry Governor (as defined below) and who otherwise has no material business relationship with a broker or dealer or an SRO registered under the Exchange Act, other than as a public director of such an SRO. See New SRO By-Laws, Article I(tt).

<sup>14</sup> An “Industry Governor” is the Floor Member Governor (as defined below), the Independent Dealer/Insurance Affiliate Governor (as defined below), the Investment Company Affiliate Governor (as defined below) or any other Governor (excluding the CEO of the New SRO and, during the Transitional Period, the CEO of NYSE Regulation) who: (a) 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 (b) has a consulting or employment relationship with or provides professional services to an SRO registered under the Exchange Act, or has had any such relationship or provided any such services at any time within the prior year. See New SRO By-Laws, Article I(t).

<sup>15</sup> See infra text accompanying notes 63 to 65 for a more detailed description of the Chair.

<sup>16</sup> During the Transitional Period, Mr. Ketchum, the current CEO of NYSE Regulation, would serve as the Chair so long as he remains a Governor. See New SRO By-Laws, Article XXII, Section 2(b).

<sup>17</sup> See supra note 13.

Governor who is registered with a member that employs at least 151 and no more than 499 registered persons (“Mid-Size Firm Governor”); (c) three Governors who are registered with members that employ at least one and no more than 150 registered persons (“Small Firm Governors” and, together with the Large Firm Governors and the Mid-Size Firm Governors, “Firm Governors”); (d) one Governor who is associated with a floor member (or a firm in the process of becoming a floor member) of the New York Stock Exchange (“Floor Member Governor”);<sup>18</sup> (e) one Governor who is associated with an independent contractor financial planning member firm or an affiliate of an insurance company (“Independent Dealer/Insurance Affiliate Governor”);<sup>19</sup> and (f) one Governor who is associated with an affiliate of an Investment Company (“Investment Company Affiliate Governor”).<sup>20</sup> During the Transitional Period, the three Small Firm Governors would be nominated by the NASD Board and elected by members that have at least one and no more than 150 registered persons, although members of that size also would have the right to nominate opposing candidates for the Small Firm Governor position. The one Mid-Size Firm Governor would 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, although members of that size also can nominate opposing candidates for the Mid-Size Firm Governor position. The three Large Firm Governors would be nominated by the NYSE Group Board and elected by members

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<sup>18</sup> See New SRO By-Laws, Article I(n).

<sup>19</sup> See New SRO By-Laws, Article I(r). See infra text accompanying note 213 for additional discussion regarding the definition of Independent Dealer/Insurance Affiliate Governor.

<sup>20</sup> See New SRO By-Laws, Article I(w). See infra text accompanying note 213 for additional discussion regarding the definition of Investment Company Affiliate Governor.

that have 500 or more registered persons, although members of that size also can nominate opposing candidates for the Large Firm Governor position. In addition, the one Floor Member Governor would be appointed by the NYSE Group Board; the one Independent Dealer/Insurance Affiliate Governor would be appointed by the NASD Board; and the one Investment Company Affiliate Governor would be appointed jointly by the NYSE Group Board and the NASD Board.<sup>21</sup>

To implement the New SRO Board structure described above, the NYSE Group Board and the NASD Board would appoint the Public Governors and Industry Governors that they, either individually or jointly, have the power to appoint, effective as of the Closing. The Public Governors, the Floor Member Governor, the Investment Company Affiliate Governor, and the Independent Dealer/Insurance Affiliate Governor would hold office for the three-year Transitional Period. The three Small Firm Governors, three Large Firm Governors, and one Mid-Size Firm Governor would be elected as Governors at the first annual meeting of members of the New SRO following the Closing, which is expected to be held within ninety days after the Closing, and would hold office until the first annual meeting of members of the New SRO following the Transitional Period.<sup>22</sup> During the interim period from the Closing until the first annual meeting of members, the Small Firm Governor, Large Firm Governor, and Mid-Size Firm Governor seats would be filled by three interim Industry Governors appointed by the NASD Board from industry governors currently on the NASD Board, three interim Industry Governors appointed by the NYSE Group Board, and one interim Industry Governor jointly appointed by the NYSE

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<sup>21</sup> See New SRO By-Laws, Article XXII, Sections 3 and 4.

<sup>22</sup> Id.

Group Board and the NASD Board, in each case prior to the Closing.<sup>23</sup>

2. Composition of the New SRO Board after the Transitional Period

The composition of the New SRO Board would remain the same after the Transitional Period, except that the term of office of the CEO of NYSE Regulation as a member of the New SRO Board would automatically terminate at the end of the Transitional Period. Thus, the authorized number of members of the New SRO Board would be reduced by one.<sup>24</sup> Other changes after the Transitional Period are described below.

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 would be divided into three classes.<sup>25</sup> The composition of the classes would be arranged as follows:<sup>26</sup>

- First class: consisting of one Large Firm Governor and one Small Firm Governor, who would be elected for a term of office expiring at the first succeeding annual meeting of members;
- Second class: consisting of one Large Firm Governor, one Mid-Size Firm Governor, and one Small Firm Governor, who would be elected for a term of office expiring at the

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<sup>23</sup> See New SRO By-Laws, Article XXII, Section 2(a).

<sup>24</sup> Under New SRO By-Laws, Article VII, Section 4 (Composition and Qualification of the Board), the total number of Governors is determined by the Board of Governors, with such number being no fewer than 16 nor more than 25 Governors. The number of Public Governors must exceed the number of Industry Governors. As a practical matter, the New SRO Board cannot have fewer than 22 Governors due to the number of designated Industry Governor positions and the requirement that the number of Public Governors must exceed the number of Industry Governors. Thus, absent the filing of a proposed rule change under Section 19(b) of the Exchange Act, there would be a minimum number of ten Industry Governors, eleven Public Governors, plus the CEO of the New SRO. See NASD Response Letter, supra note 5, at 3.

<sup>25</sup> See New SRO By-Laws, Article VII, Section 5.

<sup>26</sup> Id.



second succeeding annual meeting of members; and

- Third class: consisting of one Large Firm Governor and one Small Firm Governor, who would 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 would there be less than ten Industry Governor positions on the New SRO Board. 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 would be elected for a term of three years to replace those Governors whose terms have expired.<sup>27</sup> These Governors would serve until a successor is duly appointed and qualified, or until death, resignation, disqualification or removal. A Governor elected by the members may not serve more than two consecutive terms.

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 (“Appointed Governors”) would be divided by the New SRO 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 would initially contain as equivalent a number as possible of Appointed Governors who were members of the New SRO

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<sup>27</sup> Governors would be elected by a plurality of the votes of the members of the New SRO present in person or represented by proxy at the annual meeting of the New SRO and entitled to vote for such category of Governors. See New SRO By-Laws, Article VII, Section 13.

Board 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 New SRO Board appointed or nominated by the NASD Board or are successors to such Governor positions, on the other hand, to the extent the New SRO Board 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 would be appointed by the New SRO Board for a term of three years to replace those whose terms expire. These Governors would serve until a successor is duly appointed and qualified, or until death, resignation, disqualification or removal. No Appointed Governor may serve more than two consecutive terms.<sup>28</sup>

B. Governor Vacancies

1. During the Transitional Period

As noted above, the CEO of NYSE Regulation would be a Governor and the Chair during the Transitional Period. In the event of a vacancy in the Governor position held by Mr. Ketchum (or his successor) during the Transitional Period, the new CEO of NYSE Regulation would serve as a Governor for the remainder of the Transitional Period. If Mr. Ketchum ceases to occupy the office of Chair for any reason during the Transitional Period, then his successor as Chair would be selected by the NYSE Group Committee,<sup>29</sup> from among its members, with the exception that those Governors who also serve as NYSE Group directors may not become Chair nor may Mr.

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<sup>28</sup> See New SRO By-Laws, Article VII, Section 5.

<sup>29</sup> “NYSE Group Committee” means a committee of the New SRO Board composed of the five Public Governors and the Floor Member Governor appointed as such by the Board of NYSE Group, and the Large Firm Governors which were nominated for election as such by the Board of NYSE Group, and in each case their successors. See New SRO By-Laws, Article I(pp).

Ketchum's successor as CEO of NYSE Regulation become Chair.<sup>30</sup>

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, (a) such vacancy would be filled, and nominations for persons to fill such vacancy would be made, by the NYSE Group Committee in the case of a Large Firm Governor vacancy; (b) such vacancy would be filled by the Board, and nominations for persons to fill such vacancy would be made by the New SRO's Nominating Committee in the case of a Mid-Size Firm Governor vacancy; and (c) such vacancy would be filled, and nominations for persons to fill such vacancy would be made by the NASD Group Committee<sup>31</sup> in the case of a Small Firm Governor vacancy.<sup>32</sup> In the event the remaining term of office of any such Governor is more than twelve months, nominations would be made as set forth above, but such vacancy would be filled by the New SRO members entitled to vote on such Governor position at a meeting of members called to fill the vacancy.<sup>33</sup>

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, (a) such vacancy would be filled by, and nominations for persons to fill such vacancy would be made by the NYSE Group Committee in the case of a Floor Member Governor vacancy; (b) such vacancy would be filled by the New SRO Board, and nominations

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<sup>30</sup> See New SRO By-Laws, Article XXII, Section 2(b).

<sup>31</sup> "NASD Group Committee" means a committee of the New SRO Board composed of the five Public Governors and the Independent Dealer/Insurance Affiliate Governor appointed as such by the NASD Board in office prior to the Closing, and the Small Firm Governors which were nominated for election as such by the NASD Board in office prior to the Closing, and in each case their successors. See New SRO By-Laws, Article I(jj).

<sup>32</sup> See New SRO By-Laws, Article XXII, Section 3.

<sup>33</sup> Id.

for persons to fill such vacancy would be made by the New SRO's Nominating Committee in the case of an Investment Company Affiliate Governor vacancy; or (c) such vacancy would be filled by, and nominations for persons to fill such vacancy would be made by, the NASD Group Committee in the case of an Independent Dealer/Insurance Affiliate Governor vacancy.<sup>34</sup>

In the event of any vacancy among those Public Governors appointed by the NYSE Group Board (or their successors), such vacancy would be filled by, and nominations for persons to fill such vacancy would be made by, the NYSE Group Committee. In the event of any vacancy among those Public Governors appointed by the NASD Board (or their successors), such vacancy would be filled by, and nominations for persons to fill such vacancy would be made by, the NASD Group Committee. In the event of any vacancy of the Public Governor position jointly appointed by the NYSE Group Board and the NASD Board (or their successors), such vacancy would be filled by the New SRO Board, and nominations for persons to fill such vacancy would be made by the New SRO's Nominating Committee.<sup>35</sup>

## 2. After the Transitional Period

In the event of any vacancy among the Large Firm Governors, the Mid-Size Firm Governor, or the Small Firm Governors, such vacancy would be filled by the Large Firm Governor Committee<sup>36</sup> in the case of a Large Firm Governor vacancy, the New SRO Board in the case of a Mid-Size Firm Governor vacancy, or the Small Firm Governor Committee<sup>37</sup> in the

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<sup>34</sup>

Id.

<sup>35</sup>

Id.

<sup>36</sup>

“Large Firm Governor Committee” means a committee of the Board composed of all of the Large Firm Governors. See New SRO By-Laws, Article I(aa).

<sup>37</sup>

“Small Firm Governor Committee” means a committee of the Board composed of all the Small Firm Governors. See New SRO By-Laws, Article I(yy).

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 becomes vacant for more than twelve months, such vacancy would be filled by the members of the New SRO entitled to vote thereon at a meeting thereof convened to vote thereon.<sup>38</sup> Whether a vacancy is filled by the appropriate committee for a position that is vacant for twelve months or less or by election if the vacancy is greater than twelve months, nominations would be made by the Nominating Committee as described below.<sup>39</sup>

In the event of any vacancy among the Public Governors or among the Floor Member Governor, the Investment Company Affiliate Governor, or the Independent Dealer/Insurance Affiliate Governor after the Transitional Period, such vacancies would be filled by the New SRO Board from candidates recommended to the Board by the Nominating Committee.<sup>40</sup>

C. Committees of the New SRO Board

1. Committees Generally

a. During the Transitional Period

During the Transitional Period, the New SRO is required to have the following

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<sup>38</sup> If a Governor is appointed to fill a vacancy of an elected 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 terms. See New SRO By-Laws, Article VII, Section 5.

<sup>39</sup> See New SRO By-Laws, Article VII, Sections 5 and 9.

<sup>40</sup> Id. If a Governor is appointed to fill the vacancy of an Appointed 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 terms. See New SRO By-Laws, Article VII, Section 5.

committees of the Board<sup>41</sup>: the NASD Group Committee; the NYSE Group Committee; the Small Firm Governor Committee, and the Large Firm Governor Committee. The New SRO also is required to have an Audit,<sup>42</sup> Finance,<sup>43</sup> and Nominating Committees and, during the first year of the Transitional Period, or as may be extended thereafter by the Board, an Integration Committee.<sup>44</sup> In addition, the New SRO would have an Investment Committee, which would not be a committee of the Board.<sup>45</sup>

Unless otherwise provided in the New SRO By-Laws, any other committee having the authority to exercise the powers and authority of the New SRO Board must have a number of

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<sup>41</sup> See New SRO By-Laws, Article IX, Section 1(a). These committees play a role in the filling of vacancies on the Board and appointing the Chair of the Board of the New SRO. See New SRO By-Laws, Article XXII, Section 3.

<sup>42</sup> The Audit Committee would consist of four or five Governors, none of whom would be officers or employees of the New SRO. The Audit Committee would perform the following functions: (i) ensure the existence of adequate controls and the integrity of the financial reporting process of the New SRO; (ii) recommend to the New SRO Board, and monitor the independence and performance of, the certified public accountants retained as outside auditors by the New SRO; and (iii) direct and oversee all the activities of the New SRO's internal review function, including, but not limited to, management's responses to the internal review function. See New SRO By-Laws, Article IX, Section 5.

<sup>43</sup> The Finance Committee would consist of four or more Governors, including the CEO of the New SRO. A Finance Committee member would hold office for a term of one year. The Finance Committee would advise the Board with respect to the oversight of the financial operations and conditions of the New SRO, including recommendations for the annual operating and capital budgets and proposed changes to the rates and fees charged by the New SRO. See New SRO By-Laws, Article IX, Section 6(a)-(c).

<sup>44</sup> The Integration Committee would have a term not to exceed one year from the Closing, unless continued for a longer period by resolution of the Board. The Chair of the Board would be the Chair of the Integration Committee unless, in the case of the Integration Committee continuing beyond one year after the Closing, otherwise determined by the Board. See New SRO By-Laws, Article IX, Section 7.

<sup>45</sup> The majority of the Investment Committee during the Transitional Period would be composed 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 would be composed of members of the NYSE Group Committee. See New SRO By-Laws, Article IX, Section 6(d).

Public Governors that is greater than the number of Industry Governors.<sup>46</sup> In addition, any committee of the New SRO 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) also must 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.<sup>47</sup>

The New SRO Board may appoint an Executive Committee which can exercise all the powers and authority of the New SRO Board in the management and affairs of the New SRO between meetings of the New SRO Board, subject to the limitations in the New SRO's Certificate of Incorporation<sup>48</sup> and applicable state law.<sup>49</sup> The Executive Committee would consist of no fewer than five and no more than eight Governors. The Executive Committee would include the CEO of the New SRO and the Chair of the New SRO Board.<sup>50</sup>

b. After the Transitional Period

After the Transitional Period, the New SRO is required to have the following committees

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<sup>46</sup> See New SRO By-Laws, Article IX, Section 1(b).

<sup>47</sup> Id.

<sup>48</sup> NASD will be submitting a proposed rule change to amend its Certificate of Incorporation to reflect the New SRO By-Laws.

<sup>49</sup> See New SRO By-Laws, Article IX, Section 4(a).

<sup>50</sup> See New SRO By-Laws, Article IX, Section 4(b).

of the Board: the Small Firm Governor Committee and the Large Firm Governor Committee. New SRO also is required to have Audit, Finance, and Nominating Committees. The structure and composition of the Executive Committee, and any other committee having the authority to exercise the powers and authority of the Board, remains unchanged from that described above for the Transitional Period.

2. Nominating Committee

The Nominating Committee would be a committee of the New SRO Board and would replace the NASD's National Nominating Committee.<sup>51</sup>

a. During the Transitional Period

For the first annual meeting following the Closing, nominations for the seven elected industry seats would not be made by the Nominating Committee. Instead, the NASD Board would make nominations for the Small Firm Governors positions, the NYSE Group Board would make nominations for the Large Firm Governors positions, and the NASD Board and NYSE Group Board jointly would make the nominations for the Mid-Size Firm Governor position.<sup>52</sup> In addition, prior to the Closing, the NASD Board would identify and appoint five Public Governors and the Independent Dealer/Insurance Affiliate Governor; the NYSE Group Board would identify and appoint five Public Governors and the Floor Member Governor; and the NASD Board and the NYSE Group Board would jointly identify and appoint one Public Governor and the Investment Company Affiliate Governor.<sup>53</sup>

During the Transitional Period, members of the Nominating Committee would be

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<sup>51</sup> See New SRO By-Laws, Article I(oo) and Article VII, Section 9.

<sup>52</sup> See New SRO By-Laws, Article XXII, Section 4.

<sup>53</sup> See New SRO By-Laws, Article XXII, Section 3.



appointed jointly by the New SRO CEO and the CEO of NYSE Regulation as of Closing (or his duly appointed or elected successor as Chair of the New SRO Board), subject to ratification of the appointees by the New SRO Board.<sup>54</sup> The Nominating Committee would be responsible solely for nominating persons to fill vacancies in Governor positions for which the New SRO Board has the authority to fill, namely, the Mid-Size Firm Governor position, the Investment Company Affiliate Governor position, and the one Public Governor position that is initially appointed jointly by the NYSE Group Board and the NASD Board in office prior to the Closing.<sup>55</sup>

b. After the Transitional Period

Following the Transitional Period, the members of the Nominating Committee would be determined by the New SRO Board.<sup>56</sup> 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.<sup>57</sup> In addition, the Nominating Committee must at all times be composed of a number of Governors that is a minority of the entire New SRO Board.<sup>58</sup> The New SRO CEO may not be a member of the Nominating Committee. The Nominating Committee would be responsible for nominating persons for appointment or election to the New SRO Board, as well as nominating persons to fill vacancies in appointed or elected Governor seats.<sup>59</sup>

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<sup>54</sup> See New SRO By-Laws, Article XXII, Section 1.

<sup>55</sup> See New SRO By-Laws, Article XXII, Section 3.

<sup>56</sup> See New SRO By-Laws, Article VII, Sections 9(b) and 9(c).

<sup>57</sup> See New SRO By-Laws, Article VII, Section 9(b). At least 20% of the Nominating Committee is expected to be composed of Industry Governors. See NASD Response Letter, supra note 5, at 7.

<sup>58</sup> Id.

<sup>59</sup> See New SRO By-Laws, Article VII, Section 9(a).

D. Additional Changes

1. Annual Meetings

a. During the Transitional Period.

Except for the first annual meeting following the Closing at which Large Firm Governors, the Mid-Size Firm Governor, and Small Firm Governors would be elected, there would be no annual meetings of members during the Transitional Period.<sup>60</sup> At such first annual meeting, Small Firm members would be entitled to vote for the election of Small Firm Governors, Mid-Size Firm members would be entitled to vote for the election of the Mid-Size Firm Governor, and Large Firm members would be entitled to vote for the election of Large Firm Governors.<sup>61</sup>

b. After the Transitional Period.

An annual meeting of members of the New SRO would be held on a date and at a place as the New SRO Board designates.<sup>62</sup> The business of the annual meeting includes the election of the Small, Mid-Size, and Large Firm Governors of the New SRO Board. Small Firm members would be entitled to vote for the election of Small Firm Governors, Mid-Size Firm members would be entitled to vote for the election of the Mid-Size Firm Governor, and Large Firm members would be entitled to vote for the election of Large Firm Governors.

2. Chair

During the Transitional Period, the Chair would be the CEO of NYSE Regulation as of the Closing as long as he remains a Governor of the New SRO.<sup>63</sup> In the event the CEO of

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<sup>60</sup> See New SRO By-Laws, Article XXI, Section 1.

<sup>61</sup> Id. See also New SRO By-Laws, Article XXII, Section 3.

<sup>62</sup> Id. See also New SRO By-Laws, Article XXI, Section 1.

<sup>63</sup> See New SRO By-Laws, Article XXII, Section 2(b).

NYSE Regulation as of the Closing ceases to be the Chair during the Transitional Period, subject to the New SRO Certificate of Incorporation and the By-Laws, the Chair would be 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 nor may the successor CEO of NYSE Regulation serve as Chair.<sup>64</sup>

After the Transitional Period, the Chair would be elected by the New SRO Board from among its members.<sup>65</sup>

3. Lead Governor

The New SRO Board would have a Governor who would preside over executive sessions of the New SRO Board in the event the Chair is recused (“Lead Governor”).<sup>66</sup>

a. During the Transitional Period.

During the Transitional Period, the Lead Governor would be selected by the New SRO Board, after consultation with the New SRO’s CEO, but cannot be a member who is concurrently serving on the NYSE Group Board.<sup>67</sup> The New SRO Board, the CEO, the Chair, and the Lead Governor of the New SRO each would have the authority to call meetings of the New SRO Board.<sup>68</sup> Both the CEO and Chair, and for matters from which the CEO and Chair are recused from considering, the Lead Governor, would have the authority to place items on the New SRO Board agendas.<sup>69</sup>

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<sup>64</sup>

Id.

<sup>65</sup>

See New SRO By-Laws, Article VII, Section 4(b).

<sup>66</sup>

See New SRO By-Laws, Article I(bb) and Article VII, Section 4(b).

<sup>67</sup>

See New SRO By-Laws, Article I(bb) and Article XXII, Section 1.

<sup>68</sup>

See New SRO By-Laws, Article VII, Section 8.

<sup>69</sup>

Id.

b. After the Transitional Period.

After the Transitional Period, the New SRO Board would continue to have a Lead Governor who would preside over executive sessions of the New SRO Board in the event the Chair is not present or recused.<sup>70</sup> The Lead Governor would be elected by the Board but cannot be a member who is concurrently serving on the NYSE Group Board.<sup>71</sup> The New SRO Board, the New SRO CEO, the Chair, and the Lead Governor would have the authority to call meetings of the New SRO Board.<sup>72</sup> Both the New SRO CEO and the Chair, and for matters from which the New SRO CEO and the Chair are recused from considering, the Lead Governor, would have the authority to place items on the New SRO Board agenda.<sup>73</sup>

4. Definition of Disqualification

The New SRO By-Laws also include changes or additions to certain defined terms. In addition to changes to accommodate the New SRO's new governance structure, the proposed rule change would amend the definition of "disqualification" in the NASD By-Laws to conform to the federal securities laws, such that any person subject to a statutory disqualification under the Exchange Act also would be subject to disqualification under NASD rules.<sup>74</sup>

5. References to the NASD

In addition, NASD proposes other technical changes to its By-Laws. For example, each

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<sup>70</sup> See New SRO By-Laws, Article VII, Section 4(b).

<sup>71</sup> See New SRO By-Laws, Article I(bb).

<sup>72</sup> See New SRO By-Laws, Article VII, Section 8.

<sup>73</sup> Id.

<sup>74</sup> NASD represented that it will file a proposed rule change, which will be reviewed by the Commission pursuant to Section 19(b) of the Exchange Act, to address the applicable eligibility proceedings for persons subject to disqualification as a result of the proposed change in definition. See Notice, supra note 3.

reference to “NASD” in the NASD By-Laws would be replaced with “Corporation” in contemplation of the change in the name of the Corporation. In addition, each reference to the “Rules of the Association” in the NASD By-Laws would be replaced with “Rules of the Corporation.”

6. Proposed Changes to NASD Regulation By-Laws

In 2000, NASD created a subsidiary for its mediation and arbitration functions, NASD Dispute Resolution, pursuant to the Plan of Allocation and Delegation of Functions by NASD to Subsidiaries (“Delegation Plan”). NASD proposes to make limited conforming changes to the NASD Regulation By-Laws solely to reflect the proposed governance structure of the New SRO Board.

First, in light of the new proposed composition of the New SRO Board, the proposed rule change would amend Section 5.2 of the NASD Regulation By-Laws (Number of Members and Qualifications of the National Adjudicatory Council (“NAC”)) to eliminate the reference that the Chairman of the NAC would serve as a Governor of the NASD Board for a one-year term. Second, because the Chairman of the NAC may continue to serve as a Director of the NASD Regulation Board, the proposed rule change would eliminate the requirement in Section 4.3 of the NASD Regulation By-Laws (Qualifications) that only Governors of the NASD Board are eligible for election to the NASD Regulation Board. Finally, NASD proposes to amend the statement in Section 4.3 of the NASD Regulation By-Laws that provides that the CEO of NASD would be an ex-officio non-voting member of the NASD Regulation Board, to reflect that Ms. Schapiro would occupy both the position of CEO of the New SRO and the President of NASD Regulation. In particular, the proposed rule change would clarify that where the CEO of the New SRO also serves as President of NASD Regulation, then the person would have all powers,

including voting powers, granted to all other Directors of NASD Regulation pursuant to applicable law, the Certificate of Incorporation of NASD Regulation, the Delegation Plan, and the NASD Regulation By-Laws.

### III. Summary of Comments on the Proposal

The Commission received a total of 80 comment letters from 72 commenters on the proposal.<sup>75</sup> Seventeen commenters supported the proposed New SRO By-Laws,<sup>76</sup> some of whom believed that the consolidation proposal would streamline regulation and simplify compliance with a uniform set of regulations.<sup>77</sup> Forty-four commenters urged the Commission not to approve the proposal, generally arguing that the proposed New SRO By-Laws do not protect investors or provide enough representation for industry members or smaller member firms.<sup>78</sup> Three commenters supported the consolidation but opposed the New SRO By-Laws

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<sup>75</sup> Exhibit A to this Order contains a list of comment letters received by the Commission on the proposal as of July 16, 2007, including the citations to the comment letters referenced in this Order.

<sup>76</sup> See Vanguard Letter, Kirk Letter, SIFMA Letter, Casady Letter, Moloney Letter, Stringer Letter, Alsover Letter, Johnstone Letter, Castiglioni Letter, Robertson Letter, Pictor Letter, NAIBD Letter, FSI Letter, Bakerink Letter, NSCP Letter, Mungenast Letter, and NASAA Letter.

<sup>77</sup> See Vanguard Letter, SIFMA Letter, Castiglioni Letter, FSI Letter, NSCP Letter, and Bakerink Letter.

<sup>78</sup> See Mortarotti Letter, Lek Letter, Darcy Letter, Jordan Letter, Blumenschein Letter, Kosinsky Letter, Roberts Letter, Botzum Letter, Busacca Letter, RKeenan Letters I & II, King Letter, Flater Letter, Hebert Letter, Schunk Letter, Arnold Letter, High Letter, Eitel Letters I & II, Cohen Letter, Vande Weerd Letter, Jester Letters I & II, Schultz Letter, Benchmark Letter, Benchmark/Standard Letter I, de Leeuw Letter, Elish Letter, Hanson Letter, Horney Letter, Mayfield Letter, Solomon Letter, Patterson Letter, Daily Letter, Cray Letter, Biddick Letter, Penrod Letter, Spindel Letter, Isolano Letter, Lundgren Letters I & II, Haney Letter, Schooler Letter, Callaway Letter, John Q Letter, Miller Letters, JKeenan Letter, and Massachusetts Letter.

primarily because of the member voting provisions.<sup>79</sup> Other commenters were concerned about the fairness and independence of the arbitration process and the loss of an arbitration forum resulting from the consolidation which would allocate sole responsibility for arbitration and mediation to the New SRO.<sup>80</sup> One commenter provided copies of an amended complaint and an order relating to a lawsuit filed by an NASD member firm against NASD, NYSE Group and certain NASD officers.<sup>81</sup> Four commenters raised additional issues relating to the proposed rule

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<sup>79</sup> See Kramer Letter, IASBDA Letter, and Wachtel Letter.

<sup>80</sup> See e.g., Public Members of SICA Letter, Greenberg Letters I & II, and Caruso Letter. One commenter who objected to the consolidation also argued that investor rights would be reduced by cutting the number of arbitration venues in half. See Lundgren Letter I. As discussed below, NASD Dispute Resolution responded directly to one commenter. See NASD Dispute Resolution Letter I, *supra* note 5.

<sup>81</sup> See Johnny Q Member Letters I & II. The Commission also received a letter on behalf of Benchmark Financial Services, Inc. (“Benchmark”) and Standard Investment Chartered, Inc. (“Standard”), forwarding certain documents and pleadings relating to the lawsuit filed by Standard against the NASD, the NYSE, and three individuals defendants (Mary L. Schapiro, NASD’s CEO; Richard F. Brueckner, Presiding Governor of the NASD Board of Governors; and Barbara Z. Sweeney, NASD’s Senior Vice President and Corporate Secretary) (collectively, with NASD and NYSE, the “Defendants”) in the U.S. District Court for the Southern District of New York (“Standard Lawsuit”). See Benchmark/Standard Letter I.

The Court recently granted the Defendants’ motion to dismiss, finding that Standard had failed to exhaust its administrative remedies. See Standard Investment Chartered, Inc. v. National Association of Securities Dealers, Inc., No. 07-CV-2014 (S.D.N.Y.), 2007 WL 1296712 (May 2, 2007). On July 13, 2007, the Court denied Standard’s motion for reconsideration. See Standard Investment Chartered, Inc. v. National Association of Securities Dealers, Inc., No. 07-CV-2014 (S.D.N.Y.) (July 13, 2007) (denying Plaintiff’s Motion for Reconsideration of the Court’s May 2, 2007 Opinion and Order). Standard’s complaint alleged seven state law claims: (1) that the individual Defendants breached fiduciary duties to the proposed class in negotiating the proposed Transaction and failing to disclose all material facts in the proxy statement; (2) that the Defendants engaged in negligent misrepresentation with respect to the proxy statement; (3) that the NYSE and the individual Defendants will be unjustly enriched by the Transaction; (4) 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, 8 Del. C. § 211(a); (5) that the Defendants have improperly converted or, if the Transaction is effected, will have taken

change.<sup>82</sup> The commenters generally addressed issues falling into one or more of the categories discussed below.

A. Fair Representation

1. Classification of Member Governors

Some commenters argued that the New SRO should retain the NASD's current "one firm, one vote" election process, whereby each NASD member is currently entitled to vote for the election of all NASD Governors (other than the CEO of NASD, the President of NASD Regulation, the Chair of the NAC, and, if applicable, a second officer of NASD).<sup>83</sup> In this regard, several commenters argued that the proposal would dilute the voting rights of members in New SRO Board elections, particularly with respect to small member firms.<sup>84</sup> These commenters also expressed concern that the New SRO By-Laws would result in the New SRO's

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the prospective class members' assets and/or "Member's Equity"; (6) that the Defendants have caused a substantial diminution in the value of NASD membership, with imminent completion of such diminution; and (7) that the Defendants have deprived the prospective class members of their voting membership.

<sup>82</sup> See Harriman-Thiessen Letter (requesting that the Commission determine why NASD member firms voted the way they did), Judith Schapiro Letter (see text accompanying infra note 105), Schriener Letter (not opposed to reducing regulatory redundancies but believes that the proposed combination does not satisfy standards of "just and equitable principles of fair trade"), and Hawks Letter (see infra note 88).

<sup>83</sup> See Lek Letter, Kosinsky Letter, Roberts Letter, RKeenan Letter II, Miller Letters, Blumenschein Letter, Eitel Letter II, de Leeuw Letter, Elish Letter, Patterson Letter, Callaway Letter, Isolano Letter, Hebert Letter, Biddick Letter, John Q Letter, and Schriener Letter.

<sup>84</sup> See Mortarotti Letter, Jordan Letter, Roberts Letter, Botzum Letter, Arnold Letter, High Letter, Eitel Letter I, Cohen Letter, JKeenan Letter, Schultz Letter, Benchmark Letter, Benchmark/Standard Letter I (adding Standard to the Benchmark Letter to be an additional objector), Solomon Letter, Isolano Letter, Haney Letter, Callaway Letter, Cray Letter, Blumenschein Letter, Biddick Letter, and Wachtel Letter.



Board being dominated by the large firms at the expense of the views and concerns of the small firms.

One commenter stated that there has been insufficient review to address the concerns of small independent broker-dealers.<sup>85</sup> One commenter maintained that the current NASD By-Laws state that firms, not the number of representatives or revenues collected, dictate the “one firm, one vote rule.”<sup>86</sup> Other commenters argued that the proposal is designed to prevent the voices of the small member firms from being heard<sup>87</sup> or to eliminate small firms by escalating the cost of doing business.<sup>88</sup> Commenters also believed that there is no rational connection between the “one firm, one vote” policy and the consolidation of regulatory rules and procedures, arguing that “the NASD Board has used this regulatory consolidation . . . as a means of consolidating its power and, in turn, limiting the power of an institution that has wholly democratic origins.”<sup>89</sup>

The FSI, along with two other commenters, expressly supported the proposed New SRO By-Laws, noting that the New SRO By-Laws would provide for effective, diverse representation

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<sup>85</sup> See Horney Letter.

<sup>86</sup> See Blumenschein Letter.

<sup>87</sup> See Callaway Letter.

<sup>88</sup> See Haney Letter (defining “small” firms as those firms with one to ten representatives). Four commenters were concerned about burdensome regulation of small broker-dealers generally. See Penrod Letter (stating that small broker-dealers might be better off forming another organization designed for small broker-dealers), Hawks Letter, Roberts Letter, and Callaway Letter.

<sup>89</sup> See Benchmark Letter and Benchmark/Standard Letter I (adding Standard to the Benchmark Letter to be an additional objector). The Benchmark Letter also noted that it does not dispute that the regulatory consolidation has some merit. See also Busacca Letter (arguing that there was no specific reason given by the NASD or NYSE for “member firms . . . surrender[ing] their right to vote for their Board of Governors”).

of all members of the securities industry on the New SRO Board.<sup>90</sup> These commenters believed that the proposal is a reasonable way to maintain proper representation on the New SRO Board. The FSI also believed that the New SRO's governance structure is designed to insure that neither the largest nor the smallest broker-dealer firms can dominate the New SRO Board.<sup>91</sup> Another commenter, which identified itself as a small broker-dealer, supported the proposal and argued that small members would have increased representation on the New SRO Board as a result of the increase in their representation to three seats from the current one seat.<sup>92</sup>

## 2. Appointed Governors

Commenters were concerned that the majority of the Governors serving on the New SRO Board would be appointed by the New SRO Board itself and would not be elected by member firms.<sup>93</sup> Similarly, some commenters objected to members no longer having the right to vote for all Governors.<sup>94</sup> In addition, one commenter argued that the New SRO Board structure could create a "self-perpetuating" club in which the New SRO Board's Governors would not be held accountable to serve the members' needs.<sup>95</sup>

Some of these commenters maintained that the appointment of Governors is contrary to good corporate governance and questioned the independence and accountability of the appointed

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<sup>90</sup> See Castiglioni Letter, FSI Letter, and Bakerink Letter.

<sup>91</sup> See FSI Letter.

<sup>92</sup> See Moloney Letter.

<sup>93</sup> See Lek Letter, RKeenan Letters I & II, Hebert Letter, Mayfield Letter, Blumenschein Letter, Eitel Letter II, de Leeuw Letter, Elish Letter, Patterson Letter, Schriener Letter, Roberts Letter, and Biddick Letter.

<sup>94</sup> See Kramer Letter and Hebert Letter.

<sup>95</sup> See Wachtel Letter.

Governors.<sup>96</sup> Another commenter was concerned that the Public Governors would be appointed by the securities industry representatives on the Board.<sup>97</sup> This commenter believed that Public Governors should be chosen by the investing public or their representatives which would ensure that the views of investors would be heard and that their interests would be protected.<sup>98</sup>

### 3. Industry Representation

A number of commenters objected to the proposed composition of the New SRO Board for failing to include more industry representatives to serve as Governors.<sup>99</sup> These commenters stated that the ten Governor positions allocated to industry representatives are insufficient. These commenters also opined that the lack of industry representatives on the Board would defeat the purpose of self-regulation.

In contrast, one commenter stated that the New SRO Board structure would have too many industry representatives and not enough Public Governors.<sup>100</sup> This commenter noted that, because the New SRO Board would include ten Industry Governors as well as representatives of the NASD and NYSE Group on an ex officio basis, Governors who are from the securities industry would outnumber the Public Governors on the New SRO Board. Another commenter added that, because the current NASD definition of Public Governors would be amended, any ex-industry official or ex-industry regulator would be eligible to be a Public Governor, thereby biasing the New SRO Board toward industry interests.<sup>101</sup>

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<sup>96</sup> See Mayfield Letter, Isolano Letter, Hebert Letter, Wachtel Letter, and Lek Letter.

<sup>97</sup> See Massachusetts Letter.

<sup>98</sup> Id.

<sup>99</sup> See, e.g., Roberts Letter, Busacca Letter, Blumenschein Letter, and Miller Letters.

<sup>100</sup> See Massachusetts Letter.

<sup>101</sup> See Blumenschein Letter.

Several commenters supported the regulatory consolidation, noting that the proposed amendments are intended to maintain adequate representation on the New SRO Board for industry members.<sup>102</sup> Two commenters noted that the proposed composition of the industry members on the New SRO Board and in New SRO Board committees appears to promote diversity among industry representation on the Board.<sup>103</sup> Another commenter indicated that balanced representation of industry and non-industry members, as well as large and small firms, would reflect a broad spectrum of industry experience and would preserve the constructive feedback of non-industry participants.<sup>104</sup>

One commenter noted confusion about the proposed rule change regarding the eligibility for the “Independent Dealer/Insurance Affiliate Governor” and “Investment Company Affiliate Governor” positions.<sup>105</sup>

B. State Law and Proxy

1. Timing

Several commenters claimed that the proxy process was rushed, which forced members to make quick and uninformed decisions.<sup>106</sup> Other commenters stated that the proxy process was deceptive because it was held over the holiday season and involved alleged procedural omissions and coercive tactics by the NASD, including the threat of Commission action if the By-Law

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<sup>102</sup> See NAIBD Letter, Vanguard Letter, Moloney Letter, and FSI Letter.

<sup>103</sup> See NAIBD Letter and FSI Letter.

<sup>104</sup> See Vanguard Letter.

<sup>105</sup> See Judith Schapiro Letter.

<sup>106</sup> See Mortarotti Letter, Jordan Letter, Busacca Letter, Schunk Letter, and Cray Letter.

revisions were not approved.<sup>107</sup> Another commenter did not dispute the results of the vote but expressed concerns about the lack of discussion of alternative ways to structure the New SRO Board.<sup>108</sup>

In addition, a few commenters claimed that the NASD did not present the New SRO By-Laws to the NASD membership for a vote quickly enough, thereby violating current NASD By-Laws that require a membership vote within 30 days of the submission of the proposal to the membership.<sup>109</sup>

## 2. Disclosure

Several commenters questioned the adequacy of the proxy statement.<sup>110</sup> These commenters indicated that oral statements made by NASD staff were not contained in the proxy statement, such as representations that the Commission would force consolidation in the event the members did not support the proposal<sup>111</sup> and that the NYSE required the New SRO By-Law

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<sup>107</sup> See Benchmark Letter, Benchmark/Standard Letter I (adding Standard to the Benchmark Letter to be an additional objector), Daily Letter, Cray Letter, Eitel Letter I, Miller Letters, and John Q Letter.

<sup>108</sup> See IASBDA Letter.

<sup>109</sup> See Jester Letter I, Miller Letters, and Blumenschein Letter. In response to the NASD Response Letter, Jester submitted a supplemental comment letter, asserting that the NASD was still required to comply with Article XVI of the NASD By-Laws which requires that By-Law amendments must be approved within 30 days of the submission of the proposal to the membership, even if the By-Law amendments are approved at a special meeting. See Jester Letter II.

<sup>110</sup> See Darcy Letter, Roberts Letter, Busacca Letter, Benchmark Letter, Benchmark/Standard Letter I (adding Standard to the Benchmark Letter to be an additional objector), Benchmark/Standard Letter II, Cray Letter, Spindel Letter, and Schriener Letter.

<sup>111</sup> See Roberts Letter, Blumenschein Letter, Eitel Letter II, de Leeuw Letter, Elish Letter, Patterson Letter, Biddick Letter, Wachtel Letter, Isolano Letter, and Miller Letters.

provisions.<sup>112</sup> Two other commenters stated that the proxy statement failed to explain why the merger is connected to the governance changes, specifically the one firm, one vote policy.<sup>113</sup> These commenters also believed that the transaction is unfair to the NASD members who are not also NYSE members.<sup>114</sup> Another commenter objected to the proposed payments to the NYSE and believed that proposed consolidation needed more study by the current NASD members.<sup>115</sup>

### 3. Payment of \$35,000

Several commenters questioned the calculation and origin of the \$35,000 one-time payment to the NASD members.<sup>116</sup> Two commenters specifically posited whether the representation by the NASD that the payment came from reduced costs is misleading.<sup>117</sup> Other commenters expressed concern that the \$35,000 amount appears arbitrary and may have been calculated based on financial information the NASD knows about its member firms.<sup>118</sup> One commenter believed that the \$35,000 is a fraction of the value of the NASD,<sup>119</sup> while other

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<sup>112</sup> See Wachtel Letter.

<sup>113</sup> See Benchmark Letter and Benchmark/Standard Letter I (adding Standard to the Benchmark Letter to be an additional objector). Some commenters also noted that they were unable to get answers to their questions about the consolidation from the NASD. See, e.g., Miller Letters.

<sup>114</sup> Id.

<sup>115</sup> See Kramer Letter.

<sup>116</sup> See Kosinsky Letter, Busacca Letter, Benchmark Letter, Benchmark/Standard Letter I (adding Standard to the Benchmark Letter to be an additional objector), Benchmark/Standard Letter II, Daily Letter, Miller Letters, Wachtel Letter, John Q Letter, and Schriener Letter.

<sup>117</sup> See Busacca Letter and Schriener Letter.

<sup>118</sup> See Isolano Letter, Blumenschein Letter, Eitel Letter II, de Leeuw Letter, Elish Letter, Patterson Letter, and Biddick Letter.

<sup>119</sup> See Lundgren Letter I.

commenters wanted an explanation as to why a larger payment to members is not possible.<sup>120</sup>

One of these commenters submitted a supplemental comment letter in response to the discussion of the proposed \$35,000 payment to NASD members in the NASD Response Letter.<sup>121</sup> This commenter stated that, from the perspective of an NASD member, the focus of the proxy statement was “the fundamental change in members’ voting rights and the \$35,000 that each member is to receive in exchange for ‘surrendering’ members’ equity valued at as much as \$300,000, or more, per NASD member.”<sup>122</sup> The commenter believed that the discussion of the \$35,000 in the proposed rule change was inadequate, and stated that the Commission “should disapprove the rule change, re-notice the issue properly or limit its findings to the issues it noticed.”<sup>123</sup>

Some commenters questioned whether the payment was an improper inducement to members in order to obtain their vote.<sup>124</sup> One commenter expressed its concern that NASD member firms would receive funds for voting in favor of the consolidation, while public investors would not receive any financial benefit from the anticipated cost savings.<sup>125</sup>

Commenters also inquired whether a fairness opinion was done in connection with the

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<sup>120</sup> See Benchmark Letter, Benchmark/Standard Letter I (adding Standard to the Benchmark Letter to be an additional objector), and Benchmark/Standard Letter II.

<sup>121</sup> See Benchmark/Standard Letter II.

<sup>122</sup> Id. (also noting that at least 22 comments mentioned or raised issues relating to the \$35,000 payment, which, according to the commenter, “clearly demonstrate the materiality of the representations about the \$35,000 payment”).

<sup>123</sup> Id.

<sup>124</sup> See Eitel Letter II, Blumenschein Letter, Busacca Letter, Isolano Letter, Spindel Letter, Elish Letter, de Leeuw Letter, Patterson Letter, and Biddick Letter.

<sup>125</sup> See Caruso Letter.

consolidation or the \$35,000 payment<sup>126</sup> and whether the Internal Revenue Service gave a legal opinion on this payment.<sup>127</sup>

Two commenters believed that the monetary aspect of the proposed consolidation is simply a return of monies to the members for increased efficiency.<sup>128</sup> One of these commenters, which identified itself as a small NASD member firm, believed that the \$35,000 payment would benefit many of the small firms financially.<sup>129</sup> This commenter did not believe that members' votes were bought or that members had given up voting rights because members retain a vote on any future By-Law changes.<sup>130</sup>

#### 4. Delaware Law

One commenter argued that the proposal violates Delaware law because the omission in the proxy materials of the merger contract between NYSE and NASD makes the transaction illegal.<sup>131</sup> This commenter further believed that the proposed merger may have violated Delaware law by providing a proxy statement that allegedly had conclusory, one-sided statements.<sup>132</sup>

Another commenter argued that NASD violated Delaware law because it has not held an annual meeting in 13 months, which, according to the commenter, is required under Delaware

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<sup>126</sup> See Cohen Letter, Lundgren Letter I, and Miller Letters.

<sup>127</sup> See Daily Letter.

<sup>128</sup> See Moloney Letter and FSI Letter.

<sup>129</sup> See Moloney Letter.

<sup>130</sup> Id.

<sup>131</sup> See Cray Letter.

<sup>132</sup> Id.



law.<sup>133</sup> Another commenter stated that the proposed combination, “by combining under current unknown By-Laws,” violates the NASD’s charter as stated on August 7, 1936.<sup>134</sup>

5. Antitrust Laws

Some commenters posited that the proposal violates antitrust laws.<sup>135</sup>

C. Efficiency and Investor Protection

1. Efficiency

Some commenters explicitly questioned the benefits of the proposed consolidation.<sup>136</sup>

Three commenters argued that the consolidation would benefit mainly the larger firms;<sup>137</sup> two commenters noted specifically that firms should not have to incur costs to make changes in advertising, letterhead, and signage because the proposal mainly would benefit the larger firms.<sup>138</sup> Several commenters argued that the proposal would benefit the larger firms, while being disruptive to small broker-dealers.<sup>139</sup>

One commenter did not believe that the merger would be effective in reducing duplicative regulation because there are only about 170 firms subject to both NASD and NYSE rules.<sup>140</sup> The commenter believed that it would be easier for those 170 firms to be regulated by

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<sup>133</sup> See John Q Letter.

<sup>134</sup> See Blumenschein Letter.

<sup>135</sup> See Blumenschein Letter, Eitel Letter II, de Leeuw Letter, Elish Letter, Patterson Letter, and Biddick Letter.

<sup>136</sup> See RKeenan Letter I, Mayfield Letter, and Schooler Letter.

<sup>137</sup> See Vande Weerd Letter, Isolano Letter, and Eitel Letter II.

<sup>138</sup> See Flater Letter (also noting that the \$35,000 payment does not cover the cost of these changes) and Vande Weerd Letter.

<sup>139</sup> See Schooler Letter, Biddick Letter, de Leeuw Letter, Eitel Letter II, Elish Letter, Blumenschein Letter, Isolano Letter, and Patterson Letter.

<sup>140</sup> See Spindel Letter.

NYSE than to effect the consolidation solely for the benefit of those 170 firms.<sup>141</sup> One commenter argued that the merger is unnecessary because most firms already belong to the NASD.<sup>142</sup>

Commenters who supported the proposal believed that the proposed consolidation would benefit investors by streamlining regulation and simplifying compliance with a uniform set of regulations<sup>143</sup> or by increasing efficiency.<sup>144</sup> In this regard, some of these commenters believed that the use of two distinct rulebooks has caused unnecessary redundancy, complication, and conflict, which in their view undermines basic SRO objectives of effectively and efficiently protecting the capital markets and investors.<sup>145</sup> In addition, two commenters believed that combining the conflicting rules of the two SROs into one set of rules and eliminating inconsistent interpretations would be benefit both large and small firms.<sup>146</sup>

## 2. Investor Protection

Some commenters noted that having one less regulator overseeing the securities firms that deal with the public would harm investors.<sup>147</sup> One commenter likened the regulatory

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<sup>141</sup> Id.

<sup>142</sup> See Hebert Letter.

<sup>143</sup> See Vanguard Letter, SIFMA Letter, Stringer Letter, Bakerink Letter, NSCP Letter, and FSI Letter. In addition, six commenters stated their agreement with SIFMA's Letter. See Casady Letter, Alsover Letter, Johnstone Letter, Robertson Letter, Mungenast Letter, and Pictor Letter.

<sup>144</sup> See Moloney Letter, Kirk Letter, Castiglioni Letter, and NAIBD Letter.

<sup>145</sup> See Vanguard Letter, SIFMA Letter, and NSCP Letter. In addition, seven commenters stated their agreement with SIFMA's Letter. See Casady Letter, Alsover Letter, Johnstone Letter, Robertson Letter, Mungenast Letter, Stringer Letter, and Pictor Letter.

<sup>146</sup> See Bakerink Letter and Vanguard Letter.

<sup>147</sup> See King Letter, Eitel Letter II, de Leeuw Letter, Elish Letter, Patterson Letter, Biddick Letter, and Massachusetts Letter.

consolidation to reducing the number of “police departments” that oversee the markets.<sup>148</sup>

Another commenter stated that the proposal would remove any competitiveness between the two SROs and any choice that firms would have.<sup>149</sup> Yet another commenter added that having two independent regulatory entities would create advantages from a regulatory point of view.<sup>150</sup> This commenter noted that the NASD and NYSE are able to bring distinct perspectives to regulating their member firms and that such independence is vital to preventing SROs and other regulators from becoming myopic about certain regulatory issues. On the other hand, one commenter believed that the proposed structure would offer the best opportunity for balanced and effective regulation in furtherance of customer protection.<sup>151</sup>

Other commenters believed that the proposal overlooked investor interests because of the failure to include investors in the merger talks,<sup>152</sup> the lack of accountability and control over NASD/NYSE management by owners,<sup>153</sup> and the conflict of interest on the part of the NASD management because of benefits they may receive in connection with the merger.<sup>154</sup> Other

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<sup>148</sup> See King Letter.

<sup>149</sup> See Schooler Letter.

<sup>150</sup> See Massachusetts Letter.

<sup>151</sup> See FSI Letter.

<sup>152</sup> See King Letter. One commenter who supported the consolidation urged that compliance professionals be included in the consolidation process. See NSCP Letter.

<sup>153</sup> See Lundgren Letter I.

<sup>154</sup> See Lundgren Letter II, Eitel Letter II, de Leeuw Letter, Biddick Letter, Elish Letter, Isolano, and Patterson Letter. Several commenters also questioned the compensation packages of the NASD management. See, e.g., Isolano Letter, Mayfield Letter, and Daily Letter.

commenters questioned the effectiveness of the regulatory oversight of a board whose members are directly funded by the persons they are regulating.<sup>155</sup>

D. Arbitration

Five commenters focused on the effects the merger may have on the arbitration of customers' disputes with their brokers.<sup>156</sup> One commenter urged the Commission to disapprove the merger, stating that it would reduce investor rights "by cutting the number of major available arbitration venues in half."<sup>157</sup> Another recommended that the Commission consider holding public hearings to discuss anticipated benefits and detriments of consolidating the NASD and NYSE dispute resolution forums before approving the merger.<sup>158</sup>

One commenter expressed the view that a single SRO arbitration forum will heighten public investors' suspicion that SRO arbitration is "less than independent and hence less than fair."<sup>159</sup> This commenter suggested either creating an "independent securities arbitration forum, with SEC oversight and public investor and securities industry participation" or providing that public investors may choose between resolving their disputes in court or in arbitration. In addition, this commenter stated that the role of the Securities Industry Conference on Arbitration ("SICA") should be strengthened and that public members should compose at least one half of the voting members of SICA.

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<sup>155</sup> See Biddick Letter, de Leeuw Letter, Eitel Letter II, Elish Letter, Isolano Letter, and Patterson Letter.

<sup>156</sup> See Caruso Letter, Greenberg Letters I & II, Lundgren Letter, Massachusetts Letter, and Public Members of SICA Letter.

<sup>157</sup> See Lundgren Letter.

<sup>158</sup> See Caruso Letter.

<sup>159</sup> See Public Members of SICA Letter.

Another commenter cited those views with approval, stating that combining the NASD and NYSE arbitration forum is “not desirable” and called for changes in the arbitration system “to make it fairer to investors” including the elimination of “industry” arbitrators.<sup>160</sup> This commenter also expressed concern about the use of dispositive motions in SRO arbitration and stated that the New SRO should incorporate the relevant NYSE rule rather than the NASD rule in its arbitration code.

One commenter noted that the NASD and NYSE forums have different rules, procedures, and administrative practices, and stated this “can often have a significant procedural impact on an arbitration proceeding.”<sup>161</sup> Expressing skepticism that a single forum will provide “any recognizable benefits” for public customers, this commenter stated that a “notable portion of the anticipated cost savings” from the regulatory consolidation should be allocated toward the reduction of public investors’ filing, administrative and forum fees.

As discussed more fully below, NASD responded to comments, in part, by citing studies and reports analyzing its arbitration forum, and noting that it is subject to SEC oversight, including through inspections and the rule approval process.<sup>162</sup> One commenter questioned the methodology and impartiality of the studies and reports, as well as the efficacy of SEC oversight.<sup>163</sup> This commenter also noted that he had filed a petition for rulemaking with the Commission calling for a number of changes in arbitration rules and stated that these changes

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<sup>160</sup> See Massachusetts Letter.

<sup>161</sup> See Caruso Letter.

<sup>162</sup> See NASD Dispute Resolution Letter, supra note 5.

<sup>163</sup> See Greenberg Letters I & II.

would “correct many aspects of the arbitration process, which make the process unfair to the investing public.”<sup>164</sup>

E. Other Matters

1. Request for Delay

Several commenters argued that the proposal should be put on hold for one year,<sup>165</sup> while two other commenters<sup>166</sup> suggested tabling the proposal until after the resolution of the Standard Lawsuit.<sup>167</sup> Another commenter suggested that the Commission could approve the consolidation but require another vote in three years on the composition of the New SRO Board, after the firms and the public have had a chance to evaluate the effects of the merger.<sup>168</sup> This commenter did

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<sup>164</sup> Id. See also Request for rulemaking under the Securities Exchange Act of 1934 concerning arbitration sponsored by NASD Dispute Resolution, Submitted by Les Greenberg, Esq., File No. 4-502 (May 13, 2005).

<sup>165</sup> See Busacca Letter. Three commenters argued that the proposal should be put on hold and membership should be consulted and given the opportunity for input. See also Miller Letters, Kramer Letter, and Hebert Letter.

<sup>166</sup> See Benchmark Letter and Benchmark/Standard Letter I (adding Standard to the Benchmark Letter to be an additional objector).

<sup>167</sup> The Court recently granted the Defendants’ motion to dismiss, finding that Standard had failed to exhaust its administrative remedies. See Standard Investment Chartered, Inc. v. National Association of Securities Dealers, Inc., No. 07-CV-2014 (S.D.N.Y.), 2007 WL 1296712 (May 2, 2007). According to the Benchmark/Standard Letter II, the Plaintiffs filed a motion for reconsideration on May 17, 2007. See supra note 81. On July 13, 2007, the Court denied Standard’s motion for reconsideration. See Standard Investment Chartered, Inc. v. National Association of Securities Dealers, Inc., No. 07-CV-2014 (S.D.N.Y.) (July 13, 2007) (denying Plaintiff’s Motion for Reconsideration of the Court’s May 2, 2007 Opinion and Order).

<sup>168</sup> See IASBDA Letter. This commenter argued that a reassessment in three years might “possibly calm the concerns of a large number of small firms. . .which feel disenfranchised by a process that shows no discussion of alternatives.”

not express concern about the voting results but about the lack of any discussion of other alternatives to the New SRO Board's composition.<sup>169</sup>

Other commenters believed that the proposed regulatory consolidation should occur as soon as practicable or in the timeframe announced by the NASD and NYSE Group.<sup>170</sup> One of these commenters believed that the regulatory consolidation should proceed because a majority of the members already have given their approval to the proposed regulatory consolidation.<sup>171</sup>

## 2. Public Hearing

Two commenters urged the Commission to consider the proposal at a public hearing.<sup>172</sup> As noted above, one of these commenters recommended that the Commission consider holding public hearings to discuss anticipated benefits and detriments of consolidating the NASD and NYSE dispute resolution forums before approving the consolidation.<sup>173</sup> Another commenter stated that the Commission and government oversight committees should be part of the discussion of the consolidation.<sup>174</sup>

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<sup>169</sup> Id. A commenter suggested that, in lieu of this proposed rule change, it would be “easier for those firms that are currently regulated by NYSE to simply not be regulated by NASD at all and to instead be regulated by NYSE staff using current SEC and NYSE rules which could be supplemented by NYSE adopting many of the current NASD rules to which the large New York Stock Exchange member organizations must currently comply, since they are also NASD members.” See Spindel Letter.

<sup>170</sup> See Johnstone Letter, Casady Letter, SIFMA Letter, Moloney Letter, Stringer Letter, Alsover Letter, Robertson Letter, and Pictor Letter.

<sup>171</sup> See Moloney Letter.

<sup>172</sup> See Harriman-Thiessen Letter and Caruso Letter.

<sup>173</sup> See Caruso Letter.

<sup>174</sup> See Darcy Letter.

#### IV. NASD Response to the Comment Letters

NASD submitted two letters to respond to issues raised by the commenters, including the proposed governance structure, the proxy statement, the approval process for the By-Law amendments, and the \$35,000 payment.<sup>175</sup> NASD also submitted two letters providing opinions of counsel with respect to the approval process of the By-Law amendments and the \$35,000 payment.<sup>176</sup> In two separate letters, NASD Dispute Resolution responded to comments regarding the effects of the consolidation on arbitration of customers' disputes with member firms.

##### A. Fair Representation

NASD stated that the proposed rule change was designed to provide a “carefully balanced and calibrated governance structure that was approved by a majority of the membership,” rather than the existing NASD governance structure preferred by a number of commenters.<sup>177</sup> NASD stated that the proposed By-Law changes satisfy the statutory requirement for “fair representation” pursuant to Section 15A(b)(4) of the Exchange Act.<sup>178</sup>

##### 1. Industry Representation and Classification of Governors

In response to commenters who contended that the New SRO Board would have insufficient industry representation, NASD stated that the proposal “ensures substantial industry representation, while still maintaining the overall independence of the New SRO Board and the

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<sup>175</sup> See NASD Response Letter and NASD Supplemental Response Letter, supra note 5.

<sup>176</sup> See RLF Letter and DPW Letter, supra note 5.

<sup>177</sup> NASD Response Letter, supra note 5, at 4.

<sup>178</sup> Id. at 4-5.



numerical dominance of Public Governors” and “comfortably fits within the parameters the Commission has previously articulated to comply with the fair representation requirement.”<sup>179</sup> Specifically, NASD noted that 40% of the New SRO Board would be composed of industry representatives.<sup>180</sup> NASD also noted that the member representation on the New SRO Board would exceed the member representation of The NASDAQ Stock Market LLC (“Nasdaq”) (whose Board is composed of 20% member representatives), NYSE LLC (whose Board is wholly independent), NYSE Regulation (whose Board is wholly independent<sup>181</sup>), and would be comparable to member representation of the Chicago Stock Exchange (“CHX”) (twelve directors, of which five are “participants”) and the International Securities Exchange LLC (“ISE”) (14 directors, of which six are market participants allocated by business types).<sup>182</sup>

In response to commenters who stated that the proposed rule change would abolish the current “one-member-one-vote” governance structure and the existing right to elect all of the NASD Board seats (with the exception of the Chair of the National Adjudicatory Council and the NASD CEO, who hold seats based on position), NASD stated that the proposed governance structure ensures diversity of member representation on the New SRO Board by guaranteeing

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<sup>179</sup> Id. at 5.

<sup>180</sup> Id.

<sup>181</sup> The Commission notes that all of the directors on the Board of NYSE Regulation, with the exception of the Chief Executive Officer, must qualify as independent under the independence policy of the board of directors of NYSE Euronext. See Second Amended and Restated By-Laws of NYSE Regulation, Inc., Article III, Section 1.

<sup>182</sup> NASD Response Letter, supra note 5, at 5-7. In addition to the 14 directors cited in the NASD Response Letter, the Commission notes that the President and CEO of ISE also serves on the ISE Board of Directors for a total of 15 directors. See ISE Constitution, Article III, Section 3.2.

certain seats for different size firms and those with particular business models.<sup>183</sup> In this regard, NASD noted that small firm representation would increase from one to three guaranteed seats.<sup>184</sup> NASD also noted that the “proposed composition of and selection process for the Small Firm Governors and Large Firm Governors are identical, ensuring fairness and balance between those firms that make up the largest percentage of membership and those firms that employ the largest percentage of the registered representative population.”<sup>185</sup>

NASD noted that the “New SRO intends to maintain additional member involvement in the administration of the New SRO’s affairs through representation on District Committees, Standing Committees, the Advisory Council (consisting of the Chairs of the District Committees and the Market Regulation Committee), the Small Firm Advisory Board, disciplinary panels and the National Adjudicatory Council.”<sup>186</sup> NASD also noted that the amended By-Law changes would maintain a one-member-one-vote-system for all future By-Law changes.<sup>187</sup>

Finally, NASD noted its belief that the presence of no fewer than eleven Public Governors, none of which may have a material relationship with a broker or dealer or registered SRO, satisfies the requirement to have at least one director representative of issuers and investors.<sup>188</sup>

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<sup>183</sup> NASD Response Letter, supra note 5, at 5.

<sup>184</sup> Id.

<sup>185</sup> Id.

<sup>186</sup> Id. at 6.

<sup>187</sup> Id. at 5.

<sup>188</sup> Id.

## 2. Appointed Governors

In response to commenters who objected to the number of Governors who would be appointed rather than elected, NASD believed that these commenters failed to appreciate that the proposed governance structure “strikes a balance between the necessity of overall independence and the desire for substantial, meaningful and diverse industry representation.”<sup>189</sup> NASD noted that the proposal provides for the “Small Firm, Mid-Size Firm, and Large Firm Governors to be elected by firms of corresponding size, each with an equal vote.” NASD also noted that the proposal exceeds the representation and participation requirements of other SROs whose governance rules have previously been approved by the Commission. Specifically, NASD noted that the business combination between New York Stock Exchange, Inc. (“NYSE Inc.”) and Archipelago Holdings, Inc. satisfied a parallel fair representation standard pursuant to Section 6(b)(3) of the Exchange Act with the requirement that members could elect 20% of the boards of New York Stock Exchange LLC and NYSE Regulation and a provision allowing members to nominate directly candidates for those seats through a petition process.<sup>190</sup> NASD stated that the New SRO By-Laws would allow members to elect at least 28% of the total number of directors on the Board.<sup>191</sup> NASD noted that members may petition to place alternative candidates on the ballot for their respective member-elected seats.

NASD noted that the proposed rule change provides for three additional industry seats, namely, the Investment Company Affiliate Governor, Independent Dealer/Insurance Affiliate

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<sup>189</sup> Id. at 6.

<sup>190</sup> Id. at 5.

<sup>191</sup> Id.

Governor, and Floor Member Governor.<sup>192</sup> Moreover, NASD has committed that the Charter of the New SRO's Nominating Committee provides that at least 20% of the Committee will be composed of Industry Governors that are associated with New SRO members.<sup>193</sup> According to NASD, as a trade-off to substantial industry participation on the Board and to maintain its overall independence, "it is reasonable and sensible to ensure that public members are selected by a nominating committee and that the Board is not dominated by the industry."<sup>194</sup> NASD noted that the three appointed Industry Governors represent seats with distinct business models and that are important in informing the Board's deliberations.<sup>195</sup>

B. State Law and Proxy

In response to some commenters who contended that NASD failed to follow its existing procedures for adopting By-Law amendments, specifically obtaining approval within the 30-day timeframe as set forth in Article XVI of the NASD By-Laws,<sup>196</sup> NASD stated that it acted in a manner consistent with state law, which provides alternative means to propose and adopt certain corporate governance changes. NASD stated that Article XVI of the NASD By-Laws is not an exclusive means by which member approval of amendments to the By-Laws can be obtained.

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<sup>192</sup> Id. at 7.

<sup>193</sup> NASD Supplemental Response Letter, supra note 5, at 4. NASD also noted that the proposal establishes a Nominating Committee that would nominate candidates for each seat other than that of the CEO. The Nominating Committee would be a subset of the Board determined in number and composition by the Board from time to time, provided that the number of Public Governors on the committee must always exceed then number of Industry Governors on it. NASD Response Letter, supra note 5, at 6.

<sup>194</sup> NASD Response Letter, supra note 5, at 7.

<sup>195</sup> Id.

<sup>196</sup> Article XVI of the NASD By-Laws provides that amendments to the NASD By-Laws could become effective as of a date prescribed by the NASD Board, if the amendment is approved by a majority of the members voting within 30 days after the date of submission to the membership, and is approved by the Commission.

NASD noted that “[m]embers of a Delaware non-stock corporation, including NASD, may take action at an annual or special meeting held pursuant to 8 Del. C. § 211(a) or, unless otherwise restricted by such corporation’s certificate of incorporation, by written consent pursuant to 8 Del. C. § 228.” NASD explained that, under this authority, it convened a special meeting of NASD members pursuant to Article XXI of the NASD By-Laws at which the New SRO By-Law amendments were approved.<sup>197</sup> In addition, to further support its position, NASD submitted an opinion of counsel that, under Delaware law, “it is within the authority of the Members to approve proposed amendments to the By-Laws . . . at a special meeting held more than thirty days after the proposed By-Laws had been submitted to the Members,” and that the vote of NASD members “was a valid exercise” of the members’ franchise rights and authorized by Delaware law.<sup>198</sup>

NASD took issue with the view of several commenters that the proxy was incomplete or that certain statements by NASD management regarding the potential consequences of failing to approve the proposed By-Law changes were misleading.<sup>199</sup> NASD noted that all the issues raised by the commenters were subject to lively debate in advance of the member vote. Specifically, members received communications from both the NASD and groups opposing the transaction over a five week period that included “28 town hall meetings, conference calls, mailings, emails, and telephone calls.”<sup>200</sup> NASD stated that it “provided access to its members contact list to groups opposing the transaction, and thereby afforded these groups the opportunity

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<sup>197</sup> See NASD Response Letter, supra note 5, at 7.

<sup>198</sup> See RLF Letter, supra note 5.

<sup>199</sup> See NASD Response Letter, supra note 5, at 8-9.

<sup>200</sup> Id. at 9.

to raise all of the issues to the membership,” who approved the By-Law amendments after considering all of these arguments.<sup>201</sup> In addition, NASD noted that the “proxy statement contained an extensive discussion of the negotiations with NYSE Group, the rationale for the \$35,000 payment, and how the By-Law changes would affect the voting rights of NASD members.”<sup>202</sup> NASD maintained that the statements made prior to the member vote were consistent with the proxy statement.<sup>203</sup>

In response to commenters’ concerns regarding the amount of the \$35,000 payment to be made to members upon the Closing of the Transaction, NASD noted that the proxy statement disclosed that the \$35,000 payment was based on the expected future incremental cash flows that would result from the regulatory consolidation and was consistent with public guidance from the Internal Revenue Service (“IRS”).<sup>204</sup> In the NASD Supplemental Response Letter, NASD stated that its Certificate of Incorporation prohibits NASD from paying dividends to its members, and that doing so would result in forfeiture of NASD’s tax-exempt status under Section 501(c)(6) of the Internal Revenue Code.<sup>205</sup> NASD also explained that the proposed \$35,000 member payments did not constitute a prohibited dividend or comparable distribution, because they “are based on (and limited by) expected future incremental cash flows that would result from the

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Id.

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Id.

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Id.

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Id.

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See NASD Supplemental Response Letter, supra note 5, at 2 (citing 26 U.S.C. § 501(c)(6) (requirement that “no part” of an exempt entity’s net earnings inure to any private shareholder or individual); I.R.S. Gen. Couns. Mem. 39862 (November 22, 1991) (“There is no de minimis exception to the inurement prohibition.”); see also Spokane Motorcycle Club v. United States, 222 F. Supp. 15 1, 153-54 (E.D. Wash. 1963) (refreshments provided at no cost to club members invalidated tax exemption)).

regulatory consolidation.”<sup>206</sup> Further, NASD stated that “any direct payment unrelated to those efficiencies would be inconsistent with NASD’s tax-exempt status.”<sup>207</sup> NASD determined that “\$35,000 was the maximum member payment that the IRS could be expected, with a sufficient degree of confidence, to approve within the timeframe contemplated for the transaction.”<sup>208</sup> NASD requested a private letter ruling from the IRS approving the proposed regulatory consolidation, including the \$35,000 payment, and, according to NASD, “[i]t was on this basis that the IRS agreed to issue such a ruling.”<sup>209</sup> NASD explained that “the proxy materials accurately state that member payments in excess of \$35,000 could not be possible because such a payment, without the IRS’s approval, could ‘seriously jeopardize’ NASD’s tax-exempt status.”<sup>210</sup> To further support its position, NASD submitted an opinion of its outside tax counsel that described generally the case law, statutory provisions, and guidance published by the IRS relevant to the disclosure in the NASD’s proxy statement, and concluded that if NASD had increased the amount of the \$35,000 payment, there would have been a “serious risk” that the IRS would not have issued the rulings and that NASD could be found to violate the prohibition against private inurement.<sup>211</sup> In addition, NASD’s outside Delaware counsel stated that, because the NASD’s Certificate of Incorporation contains a prohibition against inurement, any payment

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<sup>206</sup> See NASD Supplemental Response Letter, supra note 5, at 2.

<sup>207</sup> Id. at 3.

<sup>208</sup> Id.

<sup>209</sup> Id.

<sup>210</sup> Id.

<sup>211</sup> See DPW Letter, supra note 5.

that violates the federal tax code prohibition against inurement would also be void under Delaware law.<sup>212</sup>

In response to a commenter’s question about the eligibility for the positions of the Investment Company Affiliate Governor and the Independent Dealer/Insurance Affiliate Governor, respectively, NASD stated that the “proposed rule change is intended to continue the presence on the New SRO Board of representatives from the particular business models of independent dealers/insurance companies and investment companies and to provide the Nominating Committee the flexibility to fill those Board seats with the best available candidates affiliated with a firm from those industry segments.”<sup>213</sup>

C. Efficiency and Investor Protection

NASD stated that the commenters who stated that the consolidation would result in less investor protection by reducing the number and diversity of regulators overseeing the industry overstated the value of a second, duplicative regulator and understated the benefits of the regulatory consolidation.<sup>214</sup> NASD stated that the combination would achieve “greater efficiencies, clarity and cost savings in the regulation of the financial markets” and that the “investor ultimately would be better protected by a single, more efficient regulator administering a single streamlined set of rules with the combined resources” of the two organizations.<sup>215</sup>

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<sup>212</sup> See RLF Letter, supra note 5, at 5.

<sup>213</sup> See NASD Response Letter, supra note 5, at 8.

<sup>214</sup> Id.

<sup>215</sup> Id.



D. Arbitration

NASD separately addressed comments regarding the merger of the NASD and NYSE arbitration forums.<sup>216</sup> It highlighted the results of studies commissioned by NASD<sup>217</sup> and the Commission<sup>218</sup> during the past decade, which focused on forum users' perceptions of fairness, as well as two General Accounting Office reports.<sup>219</sup> In NASD's view, "it is the quality of the forum that dictates fairness rather than an investor's ability to select one dispute resolution forum over another."<sup>220</sup> NASD also noted that it currently administers over 94% of investor disputes with broker-dealers and that over the past decade the Commission has approved consolidation of the arbitration programs of other SROs with NASD with no adverse effects.<sup>221</sup>

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<sup>216</sup> See NASD Dispute Resolution Letters I & II, supra note 5.

<sup>217</sup> NASD Dispute Resolution Letter I, supra note 5 (citing G. Tidwell, K. Foster and M. Hummell, Party Evaluations of Arbitrators: An Analysis of Data Collected from NASD Regulation Arbitrations (August 5, 1999) [http://www.nasd.com/web/groups/med\\_arb/documents/mediation\\_arbitration/nasdw\\_009528.pdf](http://www.nasd.com/web/groups/med_arb/documents/mediation_arbitration/nasdw_009528.pdf)).

<sup>218</sup> NASD Dispute Resolution Letter I, supra note 5 (citing M. Perino, Report to the SEC Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations (November 4, 2002) <http://www.sec.gov/pdf/arbconflict.pdf>).

<sup>219</sup> NASD Dispute Resolution Letter I, supra note 5 (citing Actions Needed to Address Problem of Unpaid Awards, GAO/GGD-00-115 (June 2000); Securities Arbitration: How Investors Fare, GAO/GGD-92-74 (May 11, 1992)).

<sup>220</sup> See NASD Dispute Resolution Letter I, supra note 5.

<sup>221</sup> Id. (citing Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (approving consolidation with Nasdaq); Securities Exchange Act Release No. 45094 (November 21, 2001), 66 FR 60230 (December 3, 2001) (International Securities Exchange); Securities Exchange Act Release No. 40622 (October 30, 1998), 63 FR 59819 (November 5, 1998) (American Stock Exchange); Securities Exchange Act Release No. 40517 (October 1, 1998), 63 FR 54177 (October 8, 1998) (Philadelphia Stock Exchange); Securities Exchange Act Release No. 39378 (December 1, 1997), 62 FR 64417 (December 5, 1997) (Municipal Securities Rulemaking Board)).

With respect to the independence of its forum – and the suggestion for creating an “independent” forum – NASD stated that it “is an independent forum.”<sup>222</sup> NASD explained that the majority of its Dispute Resolution Board and its National Arbitration and Mediation Committee are public representatives. It also noted that it is a member of SICA. In addition, NASD stressed that it is financially self-sufficient in that it is funded by fees charged to users of the forum – broker-dealers, their associated persons, and investors.<sup>223</sup> In this regard, NASD also stated that although the consolidation should result in economies of scale and increased efficiencies in administering the New SRO arbitration forum, investors do not contribute toward administrative costs.<sup>224</sup> Rather, NASD stated that investors “pay only the marginal (that is, direct) costs attached to their particular claim.”<sup>225</sup>

Responding to the suggestion that NASD rules provide that public investors may choose between resolving their disputes in court or in arbitration, NASD cited Shearson/American Express, Inc. v. McMahon<sup>226</sup> and subsequent cases in which the Supreme Court upheld the use of pre-dispute arbitration agreements. In NASD’s view, the commenter’s proposal “seeks to overturn federal case law dating back 20 years.”<sup>227</sup> Moreover, NASD stated that “[w]hen

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<sup>222</sup> NASD Dispute Resolution Letter I, supra note 5.

<sup>223</sup> Id.

<sup>224</sup> NASD Dispute Resolution Letter II, supra note 5.

<sup>225</sup> Id.

<sup>226</sup> 482 U.S. 220 (1987).

<sup>227</sup> NASD Dispute Resolution Letter I, supra note 5.

investors (and other parties) were offered a choice of another arbitration forum under the 2000 SICA Pilot, there was little interest.”<sup>228</sup>

NASD also noted that it “continues to make significant improvements to the dispute resolution forum to make the process more transparent, fair, and efficient for investors and others who use the forum.”<sup>229</sup> With respect to a comment on the composition of arbitration panels, NASD noted that current NASD and NYSE rules provide that customer arbitrations are resolved either by a single public arbitrator or by a panel of two public and one non-public arbitrator.<sup>230</sup> Moreover, NASD stated that it and NYSE are working to harmonize their definitions of “public” and “non-public” arbitrators, and any resulting proposed rule changes would be filed with the Commission and subject to public comment at that time.<sup>231</sup> With respect to the comments regarding the use of dispositive motions at NASD and NYSE, NASD stated that it understands that NYSE arbitrators determine whether such motions will be heard at a hearing as well as the timing of the hearing. In contrast, NASD proposed a specific rule regarding dispositive motions.<sup>232</sup> NASD indicated that it will consider the comments pertaining to dispositive motions in the context of that specific rule proposal “and may further amend the proposal.”<sup>233</sup>

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<sup>228</sup> Id. In particular, NASD noted “[t]he SICA Twelfth Report sums up the pilot’s results this way: ‘From its inception, few investors (or their attorneys) elected to proceed at a non-SRO forum.’ Based upon responses to a survey of investors, SICA reported that investors’ main reasons for not using the alternative forums were the higher fees at non-SRO forums, and a general degree of comfort with existing and more familiar procedures.”

<sup>229</sup> Id.

<sup>230</sup> NASD Dispute Resolution Letter II, supra note 5.

<sup>231</sup> Id.

<sup>232</sup> Id. (citing Securities Exchange Act Release No. 54360 (August 24, 2006), 71 FR 51879 (August 31, 2006) (File No. SR-NASD-2006-088)).

<sup>233</sup> NASD Dispute Resolution Letter II, supra note 5.

V. Discussion

After careful review, and consideration of commenters' views and the NASD's correspondence responding to comments, the Commission finds that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities association.<sup>234</sup> In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(2) of the Exchange Act,<sup>235</sup> which requires a national securities association to be so organized and have the capacity to carry out the purposes of the Exchange Act and to enforce compliance by its members and persons associated with its members with the provisions of the Exchange Act. The Commission also finds that the proposed rule change is consistent with Section 15A(b)(4) of the Exchange Act, which requires that the rules of a national securities association assure the fair representation of its members in the selection of its directors and administration of its affairs, and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer.<sup>236</sup> Further, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Exchange Act,<sup>237</sup> in that it is designed, among other things, to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest.

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<sup>234</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>235</sup> 15 U.S.C. 78o-3(b)(2).

<sup>236</sup> 15 U.S.C. 78o-3(b)(4).

<sup>237</sup> 15 U.S.C. 78o-3(b)(6).

Self regulation is the cornerstone of the regulatory system governing the U.S. securities markets. Over the years, the self-regulatory system has functioned effectively and has served investors, the securities industry, and the government well. However, NASD and NYSE and many of their members believe that the current self-regulatory system as it applies to member regulation should be simplified and duplicative rules and conflicting interpretations of such rules should be eliminated. To that end, NASD and NYSE Group have agreed to consolidate their regulation of member firms. The proposal before the Commission, which would amend the NASD By-Laws to establish the By-Laws of the New SRO, is a key component in effectuating this regulatory consolidation. These amendments would establish the structure of the New SRO, which, among other things, would be responsible for reviewing and harmonizing the duplicative NASD and NYSE rules governing member firm regulation and conflicting interpretations of those rules. NASD stated that it expects the New SRO to submit to the Commission within one year of the date of the Closing proposed rule changes that would constitute a significant portion of a harmonized rulebook, with the remaining rules being submitted to the Commission within two years of the Closing.<sup>238</sup> The Commission has requested that the New SRO provide the Commission with quarterly progress reports on the harmonization project. In the Commission's view, the consolidation of NASD and NYSE member firm regulation should help reduce unnecessary regulatory costs while, at the same time, increase regulatory effectiveness and further investor protection.

The Commission discusses below the significant aspects of the proposed amendments to the NASD By-Laws.

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<sup>238</sup> See NASD Supplemental Response Letter, supra note 5.

A. Fair Representation of Members

1. Introduction

Section 15A(b)(4) of the Exchange Act<sup>239</sup> requires that the rules of a national securities association assure the fair representation of its members in the selection of its directors and administration of its affairs. This requirement helps to assure that members have a stake in the governance of the national securities association, which is charged with self-regulatory responsibilities under the Exchange Act. Under the New SRO By-Laws, the New SRO Board initially would consist of eleven Public Governors and ten Industry Governors, including a Floor Member Governor, an Independent Dealer/Insurance Affiliate Governor, an Investment Company Affiliate Governor, three Small Firm Governors, one Mid-Size Firm Governor, and three Large Firm Governors.<sup>240</sup> The CEO of the New SRO and, during the Transitional Period, the CEO of NYSE Regulation, also would be Governors on the New SRO Board.<sup>241</sup> The three Small Firm Governors, the one Mid-Size Firm Governor, and the three Large Firm Governors (collectively, “Firm Governors”) would be elected by the members of the New SRO.<sup>242</sup>

2. Board Composition

i. Classification of Member Governors

A number of commenters, who are NASD members, argued that the New SRO should retain the NASD’s current “one firm, one vote” election process. These commenters contended that they would be disenfranchised by the New SRO By-Laws because, instead of being allowed

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<sup>239</sup> 15 U.S.C. 78o-3(b)(4).

<sup>240</sup> See New SRO By-Laws, Article VII, Section 4 and Article XXII, Section 2(a).

<sup>241</sup> See New SRO By-Laws, Article VII, Section 4, and Article XXII, Section 2.

<sup>242</sup> See New SRO By-Laws, Article I(z), Article I(dd), Article I(xx), and Article VII, Section 4(a).

to elect all Governors, New SRO members would be allowed to elect only those Governors who are from member firms that are comparable in size to their own firm.<sup>243</sup> Other commenters believed that the New SRO By-Laws would provide for effective, diverse representation of all members of the securities industry on the New SRO Board.<sup>244</sup> In response, NASD stated that the proposed governance structure ensures a diversity of member representation on the New SRO Board by guaranteeing certain seats for different size firms and for those firms with particular business models.<sup>245</sup> NASD also noted that small firm representation on the Board would increase from one to three guaranteed seats.<sup>246</sup> The Commission finds that the structure of the New SRO Board – specifically the requirement that three Governors be elected by Small Firm members, one Governor be elected by Mid-Size Firm members, and three Governors be elected by Large Firm members<sup>247</sup> – is consistent with the fair representation requirement of the Exchange Act. In the Commission’s view, this structure is a reasonable method to assure the fair representation of the New SRO’s members on the New SRO’s Board by affirmatively providing various New SRO constituencies with representation on the New SRO Board.<sup>248</sup> As a result,

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<sup>243</sup> See, e.g., Lek Letter, Kosinsky Letter, Roberts Letter, RKeenan Letter II, Miller Letters, Blumenschein Letter, Eitel Letter II, de Leeuw Letter, Elish Letter, Patterson Letter, Callaway Letter, Isolano Letter, Hebert Letter, Biddick Letter, John Q Letter, and Schriener Letter.

<sup>244</sup> See Castiglioni Letter, FSI Letter, and Bakerink Letter.

<sup>245</sup> See NASD Response Letter, supra note 5, at 5.

<sup>246</sup> Id.

<sup>247</sup> See New SRO By-Laws, Article I(z), Article I(dd), Article I(xx), and Article VII, Section 4(a).

<sup>248</sup> NASD noted that the proposed composition of and selection process for the Small Firm Governors and Large Firm Governors are identical, ensuring, according to the NASD, fairness and balance between those firms that comprise the largest percentage of membership and those firms that employ the largest percentage of the registered representative population. See NASD Response Letter, supra note 5, at 5.

neither the largest nor the smallest firms would be able to dominate the New SRO Board.

Moreover, issues or concerns of a particular New SRO constituency could be brought to the attention of, and considered by, the New SRO Board.

The Commission notes that it has previously approved a governance structure in which members are entitled to elect only those directors that are from the same class as the member.<sup>249</sup> Specifically, Primary Market Makers, Competitive Market Makers, and Electronic Access Members on the ISE are entitled to elect two directors each to represent these categories of ISE's members on the ISE Board.<sup>250</sup> In approving the governance structure of the ISE, the Commission found that the composition of the ISE Board and the selection of directors of ISE satisfied the fair representation requirement of Section 6(b)(3)<sup>251</sup> of the Exchange Act.<sup>252</sup> The Commission believes that New SRO having Governor positions based on the size of a firm is not

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<sup>249</sup> See Securities Exchange Act Release No. 53705 (April 21, 2006), 71 FR 25260 (April 28, 2006) (relating to the reorganization of the ISE into a holding company structure, whereby ISE Holdings, Inc. would be the publicly-traded holding company of ISE, the SRO) ("Release No. 53705").

<sup>250</sup> The holders of "PMM Rights," which Primary Market Makers must hold to obtain trading rights on the ISE, are entitled to elect two directors. The holders of "CMM Rights," which Competitive Market Makers must hold to obtain trading rights on the ISE, are entitled to elect two directors. The holders of "EAM Rights," which Electronic Access Members must hold to obtain trading rights on the ISE, are entitled to elect two directors. Id.

<sup>251</sup> 15 U.S.C. 78f(b)(3). Section 6(b)(3) of the Exchange Act is identical to Section 15A(b)(4) of the Exchange Act, except that Section 6(b)(3) applies to national securities exchanges and Section 15A(b)(4) applies to national securities associations.

<sup>252</sup> See Securities Exchange Act Release No. 53705 (April 21, 2006), 71 FR 25260 (April 28, 2006) (noting that the ISE's proposed governance structure was substantially the same as that of its predecessor entity). In approving the governance structure of the predecessor entity, the Commission found that the selection of six of the 15 directors on the predecessor entity's board, and the manner in which such directors are nominated and selected, satisfied the fair representation requirement of Section 6(b)(3) of the Exchange Act. See Securities Exchange Act Release No. 45803 (April 23, 2002), 67 FR 21306 (April 30, 2002) (approving the predecessor entity's governance structure).



dissimilar to the governance structure of the ISE, which allocates rights to elect Board seats based on the nature of the member's business.

ii. Appointed Governors

Several commenters expressed concern that, because some Governors would be appointed, member firms would not have the right to elect all New SRO Governors.<sup>253</sup> NASD, however, stated that these commenters “fail[ed] to appreciate that the proposed governance structure strikes a balance between the necessity of overall independence and the desires for substantial, meaningful and diverse industry representation.”<sup>254</sup> NASD noted that, under the proposed New SRO By-Laws, members not only would be entitled to elect at least 28% of the total number of Governors, but also would be represented through three additional Industry Governor positions and the potential for member-elected Governors to serve on the Nominating Committee.<sup>255</sup> NASD also noted that the Commission previously approved governance structures that provided for a lower threshold of member representation regarding the selection of an SRO's directors and administration of its affairs than in the proposed New SRO By-Laws. Specifically, NASD noted that the Commission found consistent with the fair representation requirement the governance structure of NYSE LLC, whereby members elect 20% of the wholly independent board of directors of NYSE LLC and have the right to nominate directly candidates

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<sup>253</sup> See Lek Letter, RKeenan Letter I & II, Hebert Letter, Mayfield Letter, Blumenschein Letter, Eitel Letter II, de Leeuw Letter, Elish Letter, Patterson Letter, Schriener Letter, Roberts Letter, and Biddick Letter. See also Johnny Q Member Letters I & II, Benchmark/Standard Letter I, and Benchmark Letter, which referred to the Standard Lawsuit, supra note 81.

<sup>254</sup> See NASD Response Letter, supra note 5, at 6.

<sup>255</sup> Id. at 7.

through a petition process.<sup>256</sup> NASD also noted that the Commission found that the governance structure of the Nasdaq, whose Board of Directors also is composed of 20% member representatives, satisfies the fair representation standard of the Exchange Act, and that member representation on the proposed New SRO Board would exceed that of the Nasdaq's Board of Directors.<sup>257</sup>

The Commission finds that the structure of the New SRO Board, in which specified Governors are appointed and Firm Governors are elected, is consistent with the Exchange Act. The Commission notes that New SRO members will have the right to elect a total of seven Firm Governors out of 23 Governors (22 after the Transitional Period), or approximately 30% of all Governors. The Commission previously approved structures in which members were not guaranteed the right to elect all directors.<sup>258</sup> For example, the Commission approved ISE governance documents that provide that the holding company for ISE, not ISE members, would elect eight non-industry directors. In addition, Nasdaq's governance documents provide that Nasdaq members would have the right to elect 20% of Nasdaq's directors, while the holding

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<sup>256</sup> Id. at 5 (citing Securities Exchange Act Release No. 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006) (relating to the NYSE's business combination with Archipelago Holdings, Inc.) ("Release No. 53382")).

<sup>257</sup> Id. at 6 (citing Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006)). NASD also stated that member representation on the New SRO Board is comparable to member representation on the Chicago Stock Exchange (twelve directors, of which five are members) and the International Securities Exchange (14 directors, of which six are members). Id.

<sup>258</sup> See, e.g., Release No. 53705, supra note 249 (approving the proposal to allow ISE Holdings, Inc. to elect eight non-industry directors of ISE, the holders of PMM Rights to elect two directors of ISE, the holders of CMM Rights to elect two directors of ISE, and the holders of EAM Rights to elect two directors of ISE).

company for Nasdaq would have the right to elect the remaining directors.<sup>259</sup> The Commission does not believe that the statute’s standard of fair representation requires that members have the opportunity to vote for all SRO directors.

### 3. Industry Representation

Several commenters argued that the New SRO Board lacks sufficient industry representation.<sup>260</sup> In contrast, one commenter argued that the New SRO Board would have too many industry representatives,<sup>261</sup> and other commenters supported the proposed balance between Industry Governors and Public Governors.<sup>262</sup> In response, NASD noted that the proposed governance structure ensures that at least 40% of the New SRO Board would be composed of industry representatives, which, according to the NASD, “ensures substantial industry representation, while still maintaining the overall independence of the New SRO Board and the numerical dominance of Public Governors.”<sup>263</sup>

The Commission believes that the requirement that the number of Public Governors

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<sup>259</sup> See Limited Liability Company Agreement of The NASDAQ Stock Market LLC, Section 9.

Similarly, the Board members of the Boston Options Exchange Regulation, LLC (“BOXR”) are not directly elected by options participants at the Boston Options Exchange, LLC (“BOX”). BOXR’s by-laws provide that all of the BOXR board of director positions are appointed by the Boston Stock Exchange, Inc. (“BSE”) Board, subject to two of the positions on the BOXR board being nominated by BOX options participants. BOXR has regulatory oversight authority over BOX, which is the exchange facility for BSE for the trading of standardized equity options securities. BSE is the sole shareholder of BOXR. See Securities Exchange Release No. 49065 (January 13, 2004), 69 FR 2768 (January 20, 2004) (SR-BSE-2003-04) (approving the creation of BOXR).

<sup>260</sup> See, e.g., Roberts Letter, Busacca Letter, Blumenschein Letter, Eitel Letter II, and Miller Letters.

<sup>261</sup> See Massachusetts Letter.

<sup>262</sup> See NAIBD Letter; see also FSI Letter.

<sup>263</sup> See NASD Response Letter, supra note 5, at 5.

exceed the number of Industry Governors on the New SRO Board is consistent with the Exchange Act.<sup>264</sup> Specifically, the Commission believes that this requirement represents a reasonable method to permit the New SRO Board to consider the needs of the entire SRO community, including large and small investors, issuers, and securities firms, while at the same time broadly assuring the independence of the regulatory function. The Commission notes that under the by-laws of certain other SROs and the current NASD By-Laws, the number of non-industry Governors must equal or exceed the number of industry governors (excluding the CEO).<sup>265</sup> In fact, the Commission has previously stated its belief that the fair representation requirement would not prohibit exchanges and associations from having boards of directors composed solely of independent directors (other than the CEO), and that in such case, the candidate or candidates selected by members would have to be independent.<sup>266</sup>

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<sup>264</sup> See New SRO By-Laws, Article VII, Section 4(a).

<sup>265</sup> See, e.g., Philadelphia Stock Exchange (“Phlx”) Certificate of Incorporation, Article FOURTH (b)(iii)(A) and Phlx By-Laws, Article I, Sections 1-1(o) and (p) and Article IV, Section 4-1 (providing that Phlx board will have a total of 23 governors, including twelve independent governors); and ISE Constitution, Article III, Section 3.2 (providing that the ISE Board will consist of 15 directors, including eight non-industry directors, of which two must be public representatives). Article VII, Section 4(a) of the current NASD By-Laws also provides that, 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. In the instant proposal, NASD proposes to eliminate the Non-Industry Governor category and, thus, the New SRO Board would be composed of only Industry Governors, Public Governors, the CEO of the New SRO, and, during the Transitional Period, the CEO of NYSE Regulation.

<sup>266</sup> See Release No. 53382, *supra* note 256.

The Commission previously approved NYSE Inc. governance changes that established a fully independent board (other than the CEO), finding that such a board was consistent with the Exchange Act. See Securities Exchange Act Release No. 48946 (December 17, 2003), 68 FR 74678 (December 24, 2003) (relating to the amendment and restatement of

#### 4. Nominating Committee

The New SRO would have a Nominating Committee that, during the Transitional Period, would be responsible for nominating persons to fill vacancies in Governor positions for which the full New SRO Board has the authority to fill.<sup>267</sup> Following the Transitional Period, the Nominating Committee would be responsible for nominating persons for appointment or election to the New SRO Board, as well as nominating persons to fill vacancies in appointed or elected Governor positions.<sup>268</sup>

During the Transitional Period, the Nominating Committee would not nominate candidates for the seven Firm Governor positions to be elected at the first annual meeting following the Closing.<sup>269</sup> Instead, the NASD Board as constituted prior to the Closing would make nominations for the Small Firm Governors, the NYSE Group Board as constituted prior to the Closing would make nominations for the Large Firm Governors, and the NASD Board and NYSE Group Board jointly would make the nominations for the Mid-Size Firm Governor. In addition, prior to the Closing, the NASD Board and the NYSE Group Board would identify and appoint the eleven Public Governors and the three remaining Industry Governors. The Commission believes that the process for nominating the Industry Governors to be elected by the New SRO members at the first annual meeting, to be held during the Transitional Period, is a reasonable transitional measure that combines the input of the NASD Board (which includes

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the NYSE Constitution to reform the governance and management architecture of the NYSE).

<sup>267</sup> See New SRO By-Laws, Article XXII, Section 3. During the Transitional Period, the full New SRO Board would have the authority to fill vacancies in the Investment Company Affiliate Governor position and in the Joint Public Governor position.

<sup>268</sup> See New SRO By-Laws, Article VII, Section 9.

<sup>269</sup> See New SRO By-Laws, Article XXII, Section 4.

member representatives) and the NYSE Group Board. Accordingly, the Commission finds that this transitional nominating process is consistent with the fair representation requirements of the Exchange Act.

The Nominating Committee would be composed of a number of Governors that is a minority of the entire New SRO Board.<sup>270</sup> During the Transitional Period, members of the Nominating Committee would be appointed jointly by the New SRO CEO and the CEO of NYSE Regulation as of Closing (or his duly appointed or elected successor as Chair of the New SRO Board), subject to ratification by the New SRO Board.<sup>271</sup> Following the Transitional Period, the composition of the Nominating Committee would be determined by the New SRO Board. The number of Public Governors on the Nominating Committee must equal or exceed the number of Industry Governors on the Nominating Committee.<sup>272</sup>

The Commission believes that, to satisfy the Exchange Act's fair representation requirement, the New SRO must assure that its members have a say in the nomination of Governors for the New SRO Board. Other SROs have satisfied this requirement by having at least 20% member representation on their nominating committees.<sup>273</sup> In this regard, NASD has committed that the Charter of the New SRO's Nominating Committee provides that at least 20%

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<sup>270</sup> NASD represented that a minority of the entire New SRO Board means "at least one less than half of the New SRO Board." See NASD Response Letter, supra note 5, at 6. In addition, the number of Public Governors on the Nominating Committee must equal or exceed the number of Industry Governors on the Nominating Committee, and the New SRO CEO may not be a member of the Nominating Committee. See New SRO By-Laws, Article VII, Section 9(b).

<sup>271</sup> See New SRO By-Laws, Article XXII, Section 1.

<sup>272</sup> See New SRO By-Laws, Article VII, Section 9.

<sup>273</sup> See, e.g., Securities Exchange Act Release No. 53734 (April 27, 2006), 71 FR 26589 (May 5, 2006) (SR-Phlx-2005-93); Phlx By-Laws Article X, Section 10-19(a).

of the Committee will be composed of Industry Governors that are associated with New SRO members.<sup>274</sup> The inclusion on the Nominating Committee of Industry Governors who are New SRO members should help to ensure that the input of members will be considered by the Nominating Committee when selecting nominee(s). Accordingly, the Commission finds that the structure and composition of the Nominating Committee are consistent with the fair representation requirements in Section 15A(b)(4) of the Exchange Act.

#### 5. Petition Process

The New SRO By-Laws contain a petition process that would allow Small, Mid-Size, and Large Firms to nominate one or more candidates whose name(s) would be placed on the ballot in addition to the candidates selected by the Nominating Committee.<sup>275</sup> Specifically, a candidate could be included on the ballot if at least three percent of the members entitled to vote for such candidates' election (in other words, three percent of the members entitled to vote for the Small Firm Governor, Mid-Size Firm Governor, and Large Firm Governor, respectively) petitions for the inclusion of such candidate.<sup>276</sup> In the case of petitions in support of more than one candidate for a Governor position, petitions would be required to be submitted by at least ten percent of the members entitled to vote for such nominees' election. The New SRO By-Laws also provide that

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<sup>274</sup> See NASD Supplemental Response Letter, *supra* note 5, at 4.

<sup>275</sup> See New SRO By-Laws, Article VII, Section 10.

<sup>276</sup> The Secretary of the New SRO also would be required to certify 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 candidate(s) satisfies/satisfy the classification (Large Firm, Mid-Size Firm or Small Firm) of the position(s) to be filled, based on such information provided by the candidate(s) as is reasonably necessary to make the certification. See New SRO By-Laws, Article VII, Section 10.

the New SRO would provide administrative support to the candidates in a contested election by sending up to two mailings of materials prepared by the candidates.

The Commission notes that other SROs also have comparable petition processes that allow their members to nominate opposing candidates.<sup>277</sup> The Commission finds that the proposed petition process, coupled with the New SRO By-Law provisions on Board and Nominating Committee composition, should help ensure that all New SRO members are assured fair representation in the selection of Governors of the New SRO Board and therefore is consistent with the Exchange Act.

#### 6. Future By-Law Amendments

The New SRO By-Laws contain a provision that would give members a voice in proposing changes to the New SRO By-Laws.<sup>278</sup> Specifically, amendments to the New SRO By-Laws could be proposed by a Governor or a committee appointed by the New SRO Board or any 25 members of the New SRO by petition signed by such members. Any such proposed amendment would be required to be considered by the Board. The Board, upon adoption of any such amendment to the By-Laws (except as to spelling or numbering corrections or as otherwise provided in the By-Laws) by a majority vote of the Governors then in office, would be required to submit the proposed amendments to the New SRO's members for approval. If the amendment was approved by a majority of the members voting within 30 days after the date of submission to

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<sup>277</sup> See, e.g., ISE Constitution, Article III, Section 3.10 (providing that persons entitled to elect an ISE director also would be able to nominate rival candidates) and Phlx By-Laws, Article III, Section 3.7 (providing that Phlx member organizations will be permitted to make independent nominations for designated Phlx governors, which consist of the two member governors, the two designated independent governors, and the one Philadelphia Board of Trade governor)

<sup>278</sup> See New SRO By-Laws, Article XVI, Section 1.



the membership, and were approved by the Commission as provided in the Exchange Act, it would then become effective as of a date prescribed by the Board. The Commission believes that the procedures governing amendments to the New SRO By-Laws should help ensure that all New SRO members are assured fair representation in the administration of the New SRO's affairs and therefore is consistent with the Exchange Act.

7. Member Participation on Committees

In addition, the Commission finds that New SRO members' participation on various committees further provides for the fair representation of members in the administration of the affairs of an SRO, particularly with respect to participation on committees relating to rulemaking and relating to the disciplinary process.<sup>279</sup> In this regard, NASD noted that New SRO will continue extensive member involvement in the administration of its affairs through representation on various subject matter committees, disciplinary hearing panels, and the National Adjudicatory Council.<sup>280</sup> Such member participation includes, depending on the particular Committee or group, having input on the New SRO's rulemaking process and involvement in the disciplinary process.<sup>281</sup>

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<sup>279</sup> See Release No. 53382, supra note 256, at 11260 (stating that the Commission believes that members' participation on various committees, including the Market Performance Committee of the NYSE Market, and the Regulatory Advisory Committee and Committee for Review of NYSE Regulation, further provides for the fair representation of members in the administration of the affairs of the exchange, including rulemaking and the disciplinary process, consistent with Section 6(b)(3) of the Act).

<sup>280</sup> See NASD Supplemental Response Letter, supra note 5, at 4.

<sup>281</sup> Id.

B. Representation of Issuers and Investors

Section 15A(b)(4) of the Exchange Act<sup>282</sup> requires that the rules of an association provide that one or more directors be representative of issuers and investors and not be associated with a member of the association or with a broker or dealer. In the NASD Response Letter, NASD stated that it believes that the presence of no fewer than eleven Public Governors, none of which may have a material relationship with a broker or dealer or registered SRO, satisfies the requirement to have at least one director representative of issuers and investors.<sup>283</sup> The Commission believes that the inclusion of public, non-industry representatives on New SRO Board is critical to an SRO's ability to protect the public interest.<sup>284</sup> Further, public representatives help to ensure that no single group of market participants has the ability to systematically disadvantage other market participants through the SRO governance process. The Commission believes that the New SRO Board's Public Governors could provide unique, unbiased perspectives that could enhance the ability of the New SRO's Board to address issues in a non-discriminatory fashion.

The Commission finds that the composition of the New SRO Board is consistent with the issuer and investor representation requirement of Section 15A(b)(4) of the Exchange Act.<sup>285</sup>

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<sup>282</sup> 15 U.S.C. 78o-3(b)(4).

<sup>283</sup> See NASD Response Letter, *supra* note 5, at 5.

<sup>284</sup> See Regulation of Exchanges and Alternative Trading Systems, Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) (stating that "representation of the public on an oversight body that has substantive authority and decision making ability is critical to ensure that an exchange actively works to protect the public interest and that no single group of investors has the ability to systematically disadvantage other market participants through use of the exchange governance process").

<sup>285</sup> 15 U.S.C. 78o-3(b)(4).

C. State Law, Proxy, and Other Issues Raised by Commenters<sup>286</sup>

NASD filed the proposed rule change on Form 19b-4, which provides, in Instruction E thereto, that “[t]he Commission will not approve a proposed rule change before the self-regulatory organization has completed all action required to be taken under its constitution, articles of incorporation, bylaws, rules, or instruments corresponding thereto. . . .”<sup>287</sup> In addition, Section 19(b)(2) of the Exchange Act<sup>288</sup> requires that the Commission approve an SRO’s proposed rule change only if it finds that the proposal is consistent with the requirements of the Exchange Act, and the rules thereunder applicable to the SRO. Among other things, national securities associations are required under Section 15A(b)(2) of the Exchange Act<sup>289</sup> to comply with their own rules. Thus, if NASD has failed to complete all action required to be taken under, or to comply with, its own Certificate of Incorporation or By-Laws, which are rules of the association, the Commission could not approve the proposed rule change under Section 19 of the Exchange Act.<sup>290</sup>

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<sup>286</sup> Commenters also stated that the regulatory consolidation would violate the antitrust laws. See supra Section III.B.5. With respect to the alleged violation of the antitrust laws, the Commission notes that NASD and NYSE Group filed notification reports with the Department of Justice and the Federal Trade Commission under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, and the waiting period for such a filing expired on April 6, 2007. See supra note 7.

<sup>287</sup> 17 CFR 249.819. However, the SRO is not required to complete all actions specified in any such constitution, articles of incorporation, bylaws, rules, or instruments with respect to (i) compliance with the procedures of the Exchange Act or (ii) the formal filing of amendments pursuant to state law prior to Commission approval. Id.

<sup>288</sup> 15 U.S.C. 78s(b)(2).

<sup>289</sup> 15 U.S.C. 78o-3(b)(2).

<sup>290</sup> 15 U.S.C. 78s.

A number of commenters expressed concern about the approval process for the proposed amendments to the NASD By-Laws.<sup>291</sup> Some of these commenters argued that NASD violated various aspects of Delaware law, particularly with respect to obtaining member approval within the 30-day timeframe as set forth in Article XVI of the NASD By-Laws.<sup>292</sup> Other commenters questioned the adequacy of the disclosures in the proxy statement, particularly with respect to the proposed \$35,000 payment by NASD.<sup>293</sup> In addition, the plaintiff in the Standard Lawsuit, as well as another entity, Benchmark Financial Services, Inc., through their attorneys, submitted a comment letter contending that, from the perspective of an NASD member, the focus of the proxy statement was “the fundamental change in members’ voting rights and the \$35,000 that each member is to receive in exchange for ‘surrendering’ members’ equity valued at as much as \$300,000, or more, per NASD member.”<sup>294</sup> Specifically, the Benchmark/Standard Letter II alleged an inconsistency between the statements in the proxy statement and the statements in the NASD Response Letter regarding the \$35,000 payment<sup>295</sup> and concluded that “[t]he SEC cannot approve the \$35,000 payment without determining whether the statements with respect to the

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<sup>291</sup> See supra notes 106 through 134 and accompanying text.

<sup>292</sup> See supra notes 131 through 134 and accompanying text.

<sup>293</sup> See, e.g., Johnny Q Member Letters I & II, Benchmark/Standard Letters I & II, and Benchmark Letter.

<sup>294</sup> See Benchmark/Standard Letter II.

<sup>295</sup> The Benchmark/Standard Letter II noted that the proxy statement “unequivocally states that a payment larger than \$35,000 ‘is not possible;’ that it will be ‘funded by – and therefore limited by – the expected value of the incremental cash flows that will be produced by the consolidation transaction’ and that if the ‘payment was higher, it could seriously jeopardize NASD’s status as a tax-exempt organization.’” The Benchmark/Standard Letter II then stated that the discussion of the \$35,000 payment in the NASD Response Letter – specifically the NASD’s statement that the \$35,000 “payments would fall within public IRS guidance, and the proxy statement made clear that the payments would be made by NASD” – is inconsistent with the proxy statement. See Benchmark/Standard Letter II.

Proxy Statement were truthful and complete.”<sup>296</sup> The Benchmark/Standard Letter II also argued that the discussion of the \$35,000 in the proposed rule change was inadequate because neither the proposed rule change nor the Notice “mentioned or invited comment from the public or NASD members about the \$35,000 payment.”<sup>297</sup> Accordingly, the Benchmark/Standard Letter II argued that the Commission “should disapprove the rule change, re-notice the issue properly or limit its findings to the issues it noticed.”<sup>298</sup> The Benchmark/Standard Letter I also quoted a statement in the district court’s opinion in the Standard Lawsuit in which the court responded to Standard’s contention that its lawsuit should not be dismissed for failure to exhaust administrative remedies because the Commission is an unsuitable forum in which to challenge the truthfulness of the proxy statement. The letter quoted from the district court decision as follows:

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 14a-9 promulgated thereunder by the SEC and applicable Supreme Court precedent).” (Am. Compl. ¶ [4])<sup>299</sup>

To the extent the Benchmark/Standard Letters suggested that the proxy statement delivered by the NASD to its members was not in compliance with the federal securities laws,

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<sup>296</sup> See Benchmark/Standard Letter II.

<sup>297</sup> Id.

<sup>298</sup> Id.

<sup>299</sup> See Benchmark/Standard Letter I (quoting Standard Lawsuit, 2007 WL 1296712 at \*8) (first alteration added in the Benchmark/Standard Letter I, second alteration in court decision, third alteration added here to correct the Benchmark/Standard Letter I’s omission of paragraph number).

the Commission notes that Rule 14a-9 under the Exchange Act<sup>300</sup> applies only to the solicitation of proxies with respect to securities registered pursuant to Section 12 of the Exchange Act and that none of the membership interests in NASD are so registered.<sup>301</sup>

Whether an SRO failed to complete all action required to be taken under its constitution, articles of incorporation, bylaws, rules, or similar instruments ordinarily is not an issue before the Commission at the time it considers whether to approve a proposed rule change. However, in instances where there is a dispute about whether the SRO has failed to complete all necessary action prior to Commission approval, or where there is an alleged defect in such action, the Commission generally requests the SRO to supplement the proposed rule change to address issues raised by commenters. Accordingly, the Commission requested that NASD provide additional information about the disclosures regarding the \$35,000 payment noted in the proxy statement, as well as about the fact that the time period between the submission of the proxy statement to members and the vote by members exceeded 30 days.

In response to the Commission's request, NASD submitted a supplemental response letter providing additional information about its disclosures in the proxy statement regarding the \$35,000 payment and the propriety of its decision to call a special meeting of members to amend the NASD By-Laws.<sup>302</sup> Specifically, NASD stated that "the proxy materials accurately state that member payments in excess of \$35,000 would not be possible because such a payment, without the IRS's approval, could 'seriously jeopardize' NASD's tax-exempt status."<sup>303</sup> In support of its

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<sup>300</sup> See 17 CFR 240.14a-9.

<sup>301</sup> See also Rule 14a-2 under the Exchange Act, 17 CFR 240.14a-2.

<sup>302</sup> See NASD Supplemental Response Letter, supra note 5.

<sup>303</sup> See NASD Supplemental Response Letter, supra note 5, at 3.

contention, NASD stated that Section 501(c)(6) of the Internal Revenue Code and its Certificate of Incorporation prohibit it from paying any dividends to its members.<sup>304</sup> NASD explained that any member payments in connection with the Transaction are “based on (and limited by) expected future incremental cash flows that would result from the regulatory consolidation.”<sup>305</sup> Therefore, based on “public IRS guidance, the terms of the initial agreement between NASD and NYSE Group, Inc., and the importance of preserving NASD’s tax-exempt status, NASD concluded that \$35,000 was the maximum member payment that the IRS could be expected, with a sufficient degree of confidence, to approve within the timeframe contemplated for the transaction.”<sup>306</sup> NASD stated that it reached this conclusion, and decided to request the IRS’s approval of the regulatory consolidation with a \$35,000 payment, “through the exercise of business judgment by its disinterested Board of Governors.”<sup>307</sup> According to NASD, NASD Board members “fully informed themselves concerning the economics of the transaction (in particular the projected cost savings), the practical need for IRS approval, and the likelihood of obtaining that approval before determining that \$35,000 was the maximum sum for which NASD

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<sup>304</sup> Id. In response to the statement that NASD members would be “surrendering’ members’ equity valued at as much as \$300,000” in the Benchmark Standard Letter II, NASD stated that the “combined effect of the prohibition against inurement to members of a tax-exempt organization (as outlined in [DPW Letter, supra note 5]) and of the certificate provision [which states that ‘no part of its net revenues or earnings shall inure to the benefit of any individual, subscriber, contributor, or member’] (as described in [the RLF Letter, supra note 5]) makes such an ‘equity’ distribution impermissible.” See NASD Supplemental Response Letter, supra note 5, at 2.

<sup>305</sup> See NASD Supplemental Response Letter, supra note 5, at 2.

<sup>306</sup> Id. at 3.

<sup>307</sup> Id. at 3. NASD stated that (a) a majority of the NASD Board is drawn from outside the securities industry, (b) no NASD Board member had any material conflict in connection with the proposed regulatory consolidation; and (c) no NASD Board member was dominated by anyone else with such a conflict. Id.

could seek and expect to obtain approval from the IRS” and that “the Board’s decision was taken in good faith and in full compliance with the Board members’ fiduciary duties, and the resulting business judgment is entitled to deference.”<sup>308</sup> NASD then noted that, pursuant to this business judgment, “NASD requested a private letter ruling from the IRS approving the proposed regulatory consolidation, including a one-time payment [of \$35,000] . . . based on the expected future incremental cash flows, examined in conjunction with other costs attributable to the transaction (including future dues rebates to be considered annually by the NASD Board over the following five years).”<sup>309</sup> NASD further noted that “[i]t was on this basis that the IRS agreed to issue such a ruling.”<sup>310</sup> Thus, NASD believes that the proxy materials accurately stated that payments in excess of \$35,000 per member would not be possible because any such payment, without IRS approval, could “seriously jeopardize” NASD’s tax-exempt status.<sup>311</sup>

In addition, NASD furnished two opinions of outside counsel, one from NASD’s tax counsel<sup>312</sup> and one from NASD’s Delaware counsel.<sup>313</sup> With respect to the \$35,000 member payment and pertinent to the commenters’ argument that NASD could pay members more than \$35,000 based on “member’s equity valued at as much as \$300,000, or more, per NASD member,”<sup>314</sup> NASD’s outside tax counsel described generally the case law, statutory provisions, and guidance published by the IRS relevant to the disclosure in the NASD’s proxy statement.

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Id.

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Id.

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Id.

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Id.

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See DPW Letter, supra note 5.

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See RLF Letter, supra note 5.

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See supra note 304.



This letter concluded that if NASD had increased the amount of the proposed \$35,000 payment, there would have been a serious risk that the IRS would not have issued the rulings to NASD and NASD Regulation, Inc. that the proposed Transaction, which includes the \$35,000 payment, would not affect the tax-exempt status of NASD and NASD Regulation. This letter stated that NASD “could be found to violate the prohibition against private inurement if it went forward with the proposed [\$35,000 payment] without the benefit of a ruling.”<sup>315</sup> Specifically, NASD’s outside tax counsel noted that “tax law contains an absolute prohibition on a distribution of assets by tax exempt organizations, including the NASD, to their members” but that there are limited exceptions to that prohibition for rebates of dues or fees,<sup>316</sup> distributions upon liquidation, and reasonable and appropriate expenses.<sup>317</sup> NASD’s outside tax counsel discussed each exception and concluded that “[n]one of these exceptions clearly authorizes the proposed [\$35,000 payment]” and that “the only way that NASD could make the proposed [\$35,000 payment] was by securing a private letter ruling from the IRS.”<sup>318</sup> With respect to the determination of the amount of the payment to members, NASD’s outside tax counsel stated that the proposed payment “was supported economically by the present value of the expected

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<sup>315</sup> See DPW Letter, *supra* note 5, at 4-5.

<sup>316</sup> NASD’s outside tax counsel noted that “[a]lthough the aggregate amount of the proposed Member Payments fits within the amount of allowable rebates, the rebate exception does not squarely apply here because a \$35,000 payment would far exceed the \$1,200 of current-year paid-in dues of those NASD members subject to the lowest annual payments” and “[u]nder the published rulings, a payment of \$35,000 could not be made to those small members without risking the loss of NASD’s tax exemption.” Thus, based on these published rulings, if NASD had utilized the rebate of dues and fees exception, small-firm members would receive a rebate in the range of \$1,200, while large-firm members would receive a much larger rebate. *Id.* at 3.

<sup>317</sup> *Id.* at 1-4.

<sup>318</sup> *Id.* at 1-2.

incremental future cash flows attributable to the Proposed Transaction after taking into account transaction costs, including future rebates and other reductions in fees that were described in the Proxy Statement.”<sup>319</sup> Thus, according to NASD’s outside tax counsel, the IRS approved the proposed Transaction, including the payment, “because of (i) the importance of the payment to the Proposed Transaction as a whole; (ii) the financial data presented by NASD explaining that the amount of the [\$35,000 payment] is expected to be paid out of the value of expected incremental future cash flows, rather than the value of NASD’s equity; and (iii) the unique facts and circumstances of the Proposed Transaction, including the [\$35,000 payment].”<sup>320</sup>

NASD’s outside Delaware counsel addressed both the comment that a larger member payment could have been made based on “member’s equity” and the comment that NASD should have obtained approval of the By-Law amendments within the 30-day timeframe as set forth in Article XVI of the NASD By-Laws.<sup>321</sup> With respect to the \$35,000 payment, NASD’s outside Delaware counsel stated that the language in Article 4 of NASD’s Certificate of Incorporation tracks that of the Internal Revenue Code in that no part of the organization’s net earnings may inure to the benefit of any private shareholder or individual.<sup>322</sup> NASD’s outside Delaware counsel stated that any action in contravention of the Internal Revenue Code’s prohibition on inurement would also be in contravention of the prohibition against inurement set forth in NASD’s Certificate of Incorporation and thus would be void under Delaware law.<sup>323</sup> With respect to the 30-day timeframe, NASD’s outside Delaware counsel confirmed NASD’s

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<sup>319</sup> Id. at 4.

<sup>320</sup> Id. at 4-5.

<sup>321</sup> See RLF Letter, supra note 5.

<sup>322</sup> Id. at 4-5.

<sup>323</sup> Id. at 5.

analysis that Article XVI of the NASD By-Laws provides a non-exclusive means by which member approval of amendments to the By-Laws can be obtained.<sup>324</sup>

The Commission ordinarily does not make determinations regarding state law issues but, when required to do so because state law necessarily informs its findings under the Exchange Act, it relies on the conclusions of experts or other authorities. In this regard, the Commission has relied on analysis by NASD's Delaware counsel that the vote of NASD's members at the special meeting approving the proposed amendments to the By-Laws "was a valid exercise of the Member's franchise rights and authorized by Delaware law."<sup>325</sup> With respect to the adequacy of the proxy statement, the Commission has considered the NASD's explanation regarding the proxy statement's representations about the \$35,000 payment. The Commission believes that NASD has made a prima facie showing that these representations were not misleading and that NASD's explanation is uncontradicted by the commenters' submissions regarding this matter. Accordingly, after reviewing the record in this matter, the Commission believes that NASD has provided sufficient basis on which the Commission can find that, under the Exchange Act, NASD complied with its Certificate of Incorporation and By-Laws with respect to the proxy approval process and that the proposed amendments to its By-Laws were properly approved by NASD members.

D. Approval of NASD Regulation By-Laws

The NASD Regulation By-Laws contain provisions that conflict with the proposed amendments to the NASD By-Laws.<sup>326</sup> Accordingly, NASD proposes to conform those

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<sup>324</sup> See RLF Letter and NASD Response Letter, supra note 5.

<sup>325</sup> See RLF Letter, supra note 5.

<sup>326</sup> See Section II.D.6, supra, for a description of these provisions.

provisions of the NASD Regulation By-Laws to the relevant provisions in the New SRO By-Laws. Because the proposed NASD Regulation By-Law changes conform to and reflect the proposed governance structure set forth in the New SRO By-Laws, the Commission finds that the amendments to the NASD Regulation By-Laws are consistent with the Exchange Act.

E. Efficiency and Investor Protection

Some commenters explicitly questioned the benefits of the proposed consolidation,<sup>327</sup> and other commenters noted that having one less regulator overseeing the securities firms that deal with the public would harm investors.<sup>328</sup> NASD stated that the consolidation is intended, among other things, to 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. NASD also stated that the consolidation would streamline the broker-dealer regulatory system, combine technologies, and permit the establishment of a single set of rules and a single set of examiners with complementary areas of expertise within a single SRO. The Commission believes that NASD's expectations are reasonable. In the Commission's view, the consolidation of NASD and NYSE member firm regulation is intended to help reduce unnecessary regulatory costs while, at the same time, increase regulatory effectiveness and further investor protection. The Commission notes that the Transaction holds the potential to reduce unnecessary regulatory costs because New SRO firms would deal with only one group of examiners and one enforcement staff for member firm regulation.

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<sup>327</sup> See RKeenan Letter I, Mayfield Letter, and Schooler Letter.

<sup>328</sup> See King Letter, Eitel Letter II, de Leeuw Letter, Elish Letter, Patterson Letter, Biddick Letter, and Massachusetts Letter.

F. Arbitration

Section 15A(b)(6) of the Exchange Act<sup>329</sup> provides that the rules of an association must be designed, among other things, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The Commission finds that NASD's proposal to consolidate the NASD and NYSE arbitration forums is consistent with the Act because it will maintain a fair arbitration forum available for all NYSE arbitration claims, while continuing to maintain a fair forum for NASD claims and claims that it already administers on behalf of other SROs.<sup>330</sup> Merging the NYSE arbitration program with the NASD arbitration program takes advantage of economies of scale, particularly in light of the NYSE's comparatively small caseload. Moreover, as NASD noted, it has a decade of experience in administering arbitrations on behalf of other SROs.

Commenters' suggestions for creating a separate securities arbitration forum, or providing that public investors may choose between resolving their disputes in court or in arbitration, are outside the scope of the proposed rule change. The Commission notes, however, that the Supreme Court upheld the use of pre-dispute arbitration agreements to resolve securities disputes in Shearson/American Express, Inc. v. McMahon<sup>331</sup> and subsequent cases.

NASD has the ability to impose sanctions against its members for failing to submit a dispute to arbitration, failing to comply with provisions of the NASD Code of Arbitration

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<sup>329</sup> 15 U.S.C. 78o-3(b)(6).

<sup>330</sup> In considering proposed arbitration rules and rule changes, the Commission considers their effect on the fairness of the forum. See generally Securities Exchange Act Release No. 55158 (January 24, 2007). See also Section 15A(b)(6) of the Exchange Act.

<sup>331</sup> 482 U.S. 220 (1987).

Procedure for Customer Disputes, and failing to honor an award.<sup>332</sup> In light of the policy supporting arbitration evinced by the Federal Arbitration Act<sup>333</sup> and Supreme Court precedent upholding securities industry arbitration agreements,<sup>334</sup> and the requirements of Section 19(b)(2) of the Exchange Act, the Commission cannot find as a matter of law that consolidation of the NASD and NYSE arbitration forums must be conditioned on providing customers with a choice of another dispute resolution forum.

NASD has committed to consider the comments regarding the use of dispositive motions in connection with its pending rule filing in this area.<sup>335</sup> With respect to other comments concerning the classification of arbitrators, NASD stated that it is working with the NYSE to

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<sup>332</sup> NASD Rule IM-12000.

<sup>333</sup> 9 U.S.C. 1-14.

<sup>334</sup> In 1987, the Supreme Court decided Shearson/American Express, Inc. v. McMahon, 482 U.S. 222 (1987), which determined that customers who sign predispute arbitration agreements with their brokers may be compelled to arbitrate claims arising under the Exchange Act. In a companion case, Perry v. Thomas, 482 U.S. 483 (1987), the Court concluded that an employee of a broker-dealer could be compelled to arbitrate disputes by virtue of the employee having signed a Form U-4 and because the NYSE had rule in place requiring arbitration. Two years later, the Supreme Court applied the reasoning of McMahon to compel arbitration of claims arising under the Securities Act of 1933. Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989).

Thereafter, in Gilmer v. Interstate/Johnson Lane, Corp., 500 U.S. 20 (1991), the Supreme Court determined that statutory civil rights claims may be subject to compulsory arbitration, provided that a valid arbitration agreement exists between the registered representative and the firm. Specifically, the Gilmer Court stated that “by agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial forum.” Id. at 26 (quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985)). The Court stressed that “so long as the prospective litigant effectively may vindicate [his or her] statutory cause of action in the arbitral forum, the statute will continue to serve both its remedial and deterrent function.” Id. at 28 (quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 637 (1985)).

<sup>335</sup> NASD Dispute Resolution Letter II, supra note 5.

harmonize their rules and that any resulting rule changes will be filed for Commission consideration, subject to notice and comment.<sup>336</sup>

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act, that the proposed rule change (SR-NASD-2007-023) is approved.

By the Commission.

Nancy M. Morris  
Secretary

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Id.

## **EXHIBIT A**

### **List of Comment Letters as of July 16, 2007**

1. Letter from Franco Mortarotti, Zermatt Capital Management, dated December 11, 2006 (“Mortarotti Letter”).
2. Letter from Samuel F. Lek, Lek Securities Corporation, to Christopher Cox, Chairman, Commission, dated December 15, 2006 (“Lek Letter”).
3. Letter from Mary S. Darcy, Managing Partner, The Darcy Group LLC, dated December 21, 2006 (“Darcy Letter”).
4. Letter from Michael Jordan, Control Officer/Securities Industry, dated April 4, 2007 (“Jordan Letter”).
5. Letter from Joseph Kosinsky, NASD Member, dated April 2, 2007 (“Kosinsky Letter”).
6. Letter from Judith Schapiro, dated March 30, 2007 (“Judith Schapiro Letter”).
7. Letter from Daniel W. Roberts, NASD District One Committee Member, dated March 29, 2007 (“Roberts Letter”).
8. Letter from Charles Botzum, III, dated March 29, 2007 (“Botzum Letter”).
9. Letter from John B. Busacca, III on behalf of North American Clearing, Inc., The Financial Industry Association, dated March 28, 2007 (“Busacca Letter”).
10. Letters from Robert Keenan, CEO, St Bernard Financial Services, Inc., dated March 28, 2007 and April 13, 2007 (“RKeenan Letter I” and “RKeenan Letter II,” respectively).
11. Letter from Bob and Linda King, dated April 7, 2007 (“King Letter”).
12. Letter from Joel Blumenschein, President, EZ Stocks, Inc., dated March 29, 2007 (“Blumenschein Letter”).
13. Letter from Peter J. Chepucavage, General Counsel, Plexus Consulting, dated March 26, 2007 (on behalf of the International Association of Small Broker Dealers and Advisers) (“IASBDA Letter”).
14. Letter from Donald R. Hawks, Commander, Retired, USN; President, Registered Principal, Alpha Business Control Systems Inc., dated March 28, 2007 (“Hawks Letter”).



15. Letter from the Public Members of the Securities Industry Conference on Arbitration to Christopher Cox, Chairman, Commission, dated January 12, 2007 (“SICA Public Members Letter”).
16. Letter from Gretchen Harriman-Thiessen to Christopher Cox, Chairman, Commission, dated April 4, 2007 (“Harriman-Thiessen Letter”).
17. Letters from Les Greenberg, Attorney, Law Offices of Les Greenberg, to Nancy M. Morris, Secretary, Commission, dated April 8, 2007 and April 11, 2007 (“Greenberg Letter I” and “Greenberg Letter II,” respectively).
18. Letter from Ari Gabinet, Principal, Securities Regulation, The Vanguard Group, Inc., to Nancy M. Morris, Secretary, Commission, dated April 11, 2007 (“Vanguard Letter”).
19. Letter from Douglas W. Schrinier, CEO, Harrison Douglas, Inc., dated April 11, 2007 (“Schrinier Letter”).
20. Letter from Gary L. Flater, CEO, dated April 12, 2007 (“Flater Letter”).
21. Letter from Chester Hebert, President, CIM Securities, LLC, to the Commissioners, dated April 12, 2007 (“Hebert Letter”).
22. Letter from Luke C. Schunk, Registered Representative, dated April 12, 2007 (“Schunk Letter”).
23. Letter from Eric B. Arnold, President, Fenwick Securities, Inc., dated April 12, 2007 (“Arnold Letter”).
24. Letter from Kevin J. High, Managing Director, dated April 12, 2007 (“High Letter”).
25. Letters from Mary M. Eitel dated April 12, 2007 and April 16, 2007 (“Eitel Letter I” and “Eitel Letter II,” respectively).
26. Letter from Martin J. Cohen, dated April 12, 2007 (“Cohen Letter”).
27. Letter from Sennett Kirk, Kirk Securities Corporation, dated April 12, 2007 (“Kirk Letter”).
28. Letter from Alan Vande Weerd, CFP, Eagle One Investments, LLC, dated April 12, 2007 (“Vande Weerd Letter”).
29. Letters from Jack D. Jester, to Nancy M. Morris, Secretary, Commission, dated April 5, 2007 and June 4, 2007 (“Jester Letter I” and “Jester Letter II,” respectively).
30. Letter from Francis D. de Leeuw, dated April 13, 2007 (“de Leeuw Letter”).

31. Letter from Jerome S. Keenan, Vice President, International Equities Services Inc., dated April 13, 2007 (“JKeenan Letter”).
32. Letter from Wayne A. Schultz, Esq., dated April 13, 2007 (“Schultz Letter”).
33. Letter from Peter M. Elish, President, Elish Elish, Inc., dated April 13, 2007 (“Elish Letter”).
34. Letter from Edward A. H. Siedle, President, Benchmark Financial Services, Inc., to Christopher Cox, Chairman, Commission, dated April 13, 2007 (“Benchmark Letter”).
35. Letter from Jonathan W. Cuneo, and Richard D. Greenfield, dated May 4, 2007 and June 11, 2007, with attachments (“Benchmark/Standard Letter I” and “Benchmark/Standard Letter,” respectively, and, collectively, the “Benchmark/Standard Letters”).
36. Letter from Tom Hanson, VP of Operations and Compliance, dated April 13, 2007 (“Hanson Letter”).
37. Letter from Warren R. Horney, Vice President, WFP Securities Corporation, dated April 13, 2007 (“Horney Letter”).
38. Letter from Dan Mayfield, dated April 13, 2007 (“Mayfield Letter”).
39. Letter from Sam P. Solomon, dated April 13, 2007 (“Solomon Letter”).
40. Letter from Ronald Patterson, President, Southcoast Investment Group Inc., to Christopher Cox, Chairman, Commission, dated April 13, 2007 (“Patterson Letter”).
41. Letter from Steven B. Caruso, President, Public Investors Arbitration Bar Association, dated April 16, 2007 (“Caruso Letter”).
42. Letter from Mark S. Casady, Chairman and Chief Executive Officer, Linsco/Private Ledger Financial Services, to Nancy M. Morris, Secretary, Commission, dated April 16, 2007 (“Casady Letter”).
43. Letter from Charlie Cray, Director, Center for Corporate Policy, dated April 16, 2007 (“Cray Letter”).
44. Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association (“SIFMA”), to Nancy M. Morris, Secretary, Commission, dated April 16, 2007 (“SIFMA Letter”).
45. Letter from I. P. Daily, dated April 15, 2007 (“Daily Letter”).
46. Letter from Albert Kramer, President of Kramer Securities Corporation, dated April 16, 2007 (“Kramer Letter”).

47. Letter from E. John Moloney, President and Chief Executive Officer, Moloney Securities Co., Inc., dated April 16, 2007 (“Moloney Letter”).
48. Letter from David Stringer, President, Prospera Financial Services, Inc., to Nancy M. Morris, Secretary, Commission, dated April 16, 2007 (“Stringer Letter”).
49. Letter from Deborah Castiglioni, Chief Executive Officer, Cutter & Company, to Nancy M. Morris, Secretary, Commission, dated April 16, 2007 (“Castiglioni Letter”).
50. Letter from Bonnie K. Wachtel, dated April 16, 2007 (“Wachtel Letter”).
51. Letter from Lisa Roth, Chairman, National Association of Independent Broker/Dealers (“NAIBD”), to Nancy M. Morris, Secretary, Commission, dated April 16, 2007 (“NAIBD Letter”).
52. Letter from William C. Alsover, Chairman, Centennial Securities Company, LLC, to Nancy M. Morris, Secretary, Commission, dated April 16, 2007 (“Alsover Letter”).
53. Letter from Craig M. Biddick, President, Mission Securities Corp., dated April 16, 2007 (“Biddick Letter”).
54. Letter from Donald R. Penrod, President, Penrod and Company, dated April 16, 2007 (“Penrod Letter”).
55. Letter from Howard Spindel, Senior Managing Director, Integrated Management Solutions USA, LLC, to Nancy M. Morris, Secretary, Commission, dated April 16, 2007 (“Spindel Letter”).
56. Letter from William A. Johnstone, President and CEO, D.A. Davidson & Co., to Nancy M. Morris, Secretary, Commission, dated April 16, 2007 (“Johnstone Letter”).
57. Letter from David Isolano, Chief Executive Officer, Max International Broker Dealer Corp., dated April 16, 2007 (“Isolano Letter”).
58. Letters from Kathryn L. Lundgren, dated April 16, 2007 (“Lundgren Letter I”) and April 17, 2007 (“Lundgren Letter II”).
59. Letter from Gary L. Haney, Chief Executive Officer, United Insurance Group, Inc., dated April, 14, 2007 (“Haney Letter”).
60. Letter from John E. Schooler, President, WFP Securities, dated April, 13, 2007 (“Schooler Letter”).

61. Letter from Corey N. Callaway, President, Callaway Financial Services, Inc., dated April 13, 2007 (“Callaway Letter”).
62. Letters from Johnny Q Member, to Nancy M. Morris, Secretary, Commission, dated April 16, 2007, with attachments (“Johnny Q Member Letter I” and “Johnny Q Member Letter II,” respectively).
63. Letter from John Q., NASD Member, dated April 13, 2007 (“John Q Letter”).
64. Letters from Mike Miller, President, Miller Financial Corp., dated April 15, 2007, with attachment (“Miller Letters” collectively).
65. Letter from Dale E. Brown, Executive Director and CEO, Financial Services Institute, to Nancy M. Morris, Secretary, Commission, dated April 16, 2007 (“FSI Letter”).
66. Letter from William R. Pictor, President, Trubee, Collins & Co., Inc., to Nancy M. Morris, Secretary, Commission, dated April 16, 2007 (“Pictor Letter”).
67. Letter from Walter S. Robertson, III, President and CEO, Scott & Stringfellow, Inc., to Nancy M. Morris, Secretary, Commission, dated April 16, 2007 (“Robertson Letter”).
68. Letter from M. LaRae Bakerink, CEO, WBB Securities, LLC, to Christopher Cox, Chairman, Commission, dated April 16, 2007 (“Bakerink Letter”).
69. Letter from William F. Galvin, Secretary of the Commonwealth, Commonwealth of Massachusetts, to Nancy M. Morris, Secretary, Commission, dated April 18, 2007 (“Massachusetts Letter”).
70. Letter from Joseph P. Borg, President, North American Securities Administrators Association, Inc., and Director, Alabama Securities Commission, to Nancy M. Morris, Secretary, Commission, dated April 17, 2007 (“NASAA Letter”).
71. Letter from Joan Hinchman, Executive Director, President and CEO, National Society of Compliance Professional Inc., to Nancy M. Morris, Secretary, Commission, dated April 26, 2007 (“NSCP Letter”).
72. Letter from Michael J. Mungenast, CEO and President, Proequities, to Nancy M. Morris, dated April 23, 2007 (“Mungenast Letter”).