REPORT OF THE AMERIVET DEMAND COMMITTEE OF THE FINANCIAL INDUSTRY REGULATORY AUTHORITY, INC.

September 13, 2010

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A member of the Financial Industry Regulatory Authority, Inc. ("FINRA") demanded that FINRA assert legal claims to recover some or all of (1) FINRA's investment losses in 2008 and (2) any "excessive" compensation paid to FINRA's senior management in 2007, 2008 and 2009 (the "Demand"). The Demand specified that the 2008 investment losses and "excessive" compensation should be recovered from the members of FINRA's Board and relevant committees, senior management, outside investment and compensation advisors and counsel. The Board of Governors of FINRA (the "Board") thereafter established a special committee (the "Committee") to investigate and evaluate potential claims and report to the Board. The Committee has conducted a thorough investigation of potential claims. This is the Committee's report to the Board.[1]

EXECUTIVE SUMMARY

The Demand was made by Amerivet Securities, Inc. ("Amerivet") in a letter to the Board dated December 4, 2009 (the "Demand Letter"). Over the course of seven months, the Committee investigated the matters raised by the Demand. During that time period, the Committee reviewed the Demand, obtained the advice of counsel concerning the law applicable to the legal claims proposed by the Demand, and met telephonically, generally on a weekly basis, to discuss and evaluate the information obtained to date during the investigation and to direct the gathering of additional information. The Committee and its counsel requested and reviewed thousands of pages of pertinent documents. The Committee also conducted interviews of numerous individuals believed to have information relevant to the investigation, including

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1 For purposes of this report, the term "FINRA" is used to describe both the Financial Industry Regulatory Authority, Inc. and its predecessor, the National Association of Securities Dealers, Inc., which in 2007 merged with NYSE Regulation, Inc. to form FINRA.

members of an Ad Hoc Investment Committee, the Investment Committee, the Finance Committee, the Management Compensation Committee (the "Compensation Committee") and the Board. It also interviewed current and former members of senior management and representatives of FINRA's investment advisors and FINRA's compensation consultant.

As set forth in more detail herein, the Demand Letter asserts that those responsible for making decisions concerning FINRA's investments "knew or should have known" that the investments were "highly risky" and "unjustified." The Demand Letter further asserts that such persons were "reckless" in making the investments. The Committee has determined that these assertions are not correct.

The Committee found that the 2008 investment losses stemmed from the investment of FINRA's available funds in the manner of a diversified college endowment, which included investments in equities, fixed income securities and alternatives, including hedge funds, private equity and real assets. The 2008 losses were indeed similar to those incurred during the same time period by other endowments and foundations. The Committee found that the decision to invest in the manner of an endowment was initially made in 2003, upon the recommendation of an Ad Hoc Investment Committee. It was reconsidered and reaffirmed in 2006 during a joint meeting of the Finance and Investment Committee. It was reconsidered again in 2008 by the Investment Committee.

The members of the Board and committees that considered and reaffirmed the decision had no personal interests in the decision different from those of FINRA's members generally and did not lack independence from any person having such an interest; they therefore were disinterested and independent in making and reaffirming the decision. Such members included highly experienced investment professionals, with different view points, including, at various times, current and former senior executives of the Harvard Management Company, The

Vanguard Group, The Travelers Companies, Inc., the Notre Dame endowment and the California Public Employees' Retirement System.

In making and reaffirming the endowment decision, the relevant Board or committee based its decisions both upon the substantial collective experience of its members and relevant information provided by FINRA's management and investment advisors. The information considered included the expected return and risk of alternative portfolios, the historical correlation of returns on the asset classes being considered, the likelihood that losses would exceed specified thresholds based upon the historical performance of the assets classes and FINRA's projected cash flow requirements to satisfy its operating budget and rebates to members. Also, in making and reconsidering the decision, the relevant Board or committee engaged in thoughtful deliberations, including at times debate among Board or committee members with different views.

The picture that emerges from the information obtained during the investigation and summarized above is of disinterested and independent Board and committee members working in good faith, diligently and laboriously, to determine and repeatedly reconsider the optimal mix of investments to maximize the return on the investments over the long term without undue risk. The decision to invest in the manner of a diversified endowment was neither unusual nor unreasonable – it was indeed consistent with strategies employed at the time by many experienced and thoughtful fiduciaries. Nor, with the benefit of hindsight, is it clear that the decision was a poor one. The gains produced by the decision during only the few years before and after the 2008 market decline more than offset the losses during the decline, with the result that the return on the portfolio since the endowment decision was made was positive and exceeded the returns on alternatives, such as the S&P 500 and Treasury Bills. For these reasons, and others detailed herein, and based upon the advice of counsel summarized herein, the

Committee concludes that FINRA does not have viable claims by which it might recover some or any portion of the 2008 investment losses. It recommends against the assertion of such claims.

The Demand Letter also asserts that those responsible for making compensation decisions for FINRA approved compensation paid to senior executives in 2007, 2008 and 2009 that was "wholly inconsistent" with compensation paid by government agencies and not-for-profits. The Demand Letter further states that the compensation was "grossly excessive" and "wholly unjustified" in view of asserted regulatory failures by FINRA. The Demand Letter focuses specifically on "performance bonuses" paid to senior management in 2007-2009. It also focuses on an asserted "'going away' gift" "valued as high as $25 million" that was allegedly paid to FINRA's outgoing chief executive officer, Mary Schapiro, in 2009. The Committee has determined that these assertions are also misplaced.

The compensation decisions for FINRA's senior executives other than its chief executive officer were made by the Compensation Committee. The decisions for the chief executive officer were made by the Board. The members of these bodies during the relevant time period had no personal interests in the decisions and did not lack independence from the senior executives whose compensation they approved; they therefore were disinterested and independent in approving the compensation. The members of the Compensation Committee and Board set the compensation paid to the senior executives and chief executive officer so that it was competitive with the compensation paid by the employers with whom FINRA competes most directly for employees. The members of the Compensation Committee repeatedly scrutinized the data for comparable employers to ensure that FINRA was relying upon data for employers who were truly most comparable. In approving compensation for each senior executive, including the chief executive officer, the Compensation Committee or Board took into

account available information concerning both the performance of the executive and FINRA's performance generally.

Upon her departure from FINRA, Ms. Schapiro did not receive a $25 million gift. She rather received $8,985,334.02, most of which consisted of the lump sum payment of the retirement benefits that had accrued in her favor during her thirteen year tenure with FINRA. Most of the remainder consisted of incentive compensation for 2008 to which she was contractually entitled. After taking into consideration all forms of compensation, including base salary, incentive compensation and retirement benefits, the total compensation paid to or accrued in favor of Ms. Schapiro during the relevant time period was not more than competitive with the comparable groups.

The Committee has determined that the compensation decisions made by the Compensation Committee and Board were made in good faith to ensure that FINRA paid its senior executives no more than reasonably required to enable FINRA to hire and retain the quality of executives needed to carry out effectively FINRA's regulatory mission. Based upon the facts summarized above, and the advice of counsel summarized herein, the Committee concludes that FINRA does not have viable claims to recover any compensation paid to FINRA's senior executives, including Ms. Schapiro, during the years 2007-2009. The Committee recommends that no such claims be asserted.

The Committee also has investigated potential claims against FINRA's investment advisor and compensation consultant during the relevant time period. The Committee found that both were reputable professionals with national reputations for excellence. They acted professionally and in good faith in providing data and advice to the relevant governing bodies of FINRA. The Committee found nothing about their work that deviated from standards generally applicable for investment advisors and compensation consultants respectively. Counsel for

FINRA was not involved in compensation decisions and had only a minor role in investment decisions. To the extent that counsel was involved, the Committee found nothing about their work that deviated from applicable standards.

BACKGROUND OF THE INVESTIGATION

I. THE DEMAND

The Demand was made by Amerivet in a letter to the Board dated December 4, 2009. In the Demand Letter, Amerivet demands that FINRA commence legal proceedings to recover the investment losses incurred in 2008 and thereafter.[2] The Demand Letter explains that FINRA's Investment Committee "knew or should have known that FINRA had engaged and [was] engaging in highly risky and unjustified financial transactions to generate apparent short-term gains at the expense of their longer-term consequences."[3] The Demand Letter explains that the Investment Committee and its "subordinates" have been "reckless in pursuing high-risk strategies inappropriate to preservation of capital."[4] It further states that the losses sustained by FINRA in 2008 were "inconsistent" with FINRA's stated investment policy.[5]

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[2] FINRA did not incur month-over-month investment losses between February 2009 and the time that Amerivet made the Demand.

[3] Demand Letter at 5-6.

[4] Demand Letter at 5.

[5] Demand Letter at 5. The Demand Letter quotes language from FINRA's 2008 Year in Review and Annual Financial Report (the "2008 Annual Report"). The 2008 Annual Report states: "The purpose of the portfolio is to support FINRA's operations and fulfill its mission of investor protection and market integrity by providing FINRA with supplemental financial resources to allow it to implement long-range plans. FINRA's investment policy is set forth to preserve principal over the long-term (in real terms) while seeking to maximize returns within acceptable levels of risk, and to do so in a manner consistent with portfolio management best practices for producing long-term returns." 2008 Annual Report at 29. Similar statements were made in earlier Annual Reports, except that earlier statements used the phrase "consistent with endowment best practices" in place of "consistent with portfolio management best practices." *See, e.g.*, 2007 Annual Report at 24, 2006 Annual Report at 26. The Committee has concluded, for the reasons described in this report, that the investment decisions of the Investment Committee, the Finance Committee and the Board were consistent with these statements. *See infra* at 25-56.

In the Demand Letter, Amerivet also demands that FINRA commence legal proceedings to recover "excessive" compensation paid to the members of FINRA's senior management.[6] The Demand Letter specifies that such compensation includes "performance bonuses" paid to senior management in the years 2007, 2008 and 2009 and "termination-related compensation paid and to be paid to CEO Mary Schapiro" in 2009.[7] It states that the compensation was "wholly unjustified" and "grossly excessive" in view of the performance of the persons receiving such compensation.[8] On the subject of the performance of senior management, the Demand Letter provides a description of asserted regulatory failures by FINRA.[9] The Demand Letter also explains that the compensation was "wholly inconsistent with compensation paid to SEC and other regulators and to executives of non-profit corporations."[10]

The Demand Letter specifies that the proposed claims should be asserted against the members of the Board, the Investment Committee, the Compensation Committee, FINRA's senior management, FINRA's investment advisors and counsel and "all those other persons or entities who have aided and abetted or otherwise participated in such wrongdoing."[11] The Demand Letter proposes claims for breaches of fiduciary duty, waste of corporate assets and

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6 Demand Letter at 4.

7 Demand Letter at 2, 5.

8 Demand Letter at 4.

9 Demand Letter at 2-4.

10 Demand Letter at 4.

11 Demand Letter at 1.

unjust enrichment.[12] It proposes that FINRA seek both damages and, as to the compensation, also injunctive relief for an accounting and repayment of any unjust enrichment.[13]

II. THE FORMATION OF THE DEMAND COMMITTEE

On February 10, 2010, in response to the Demand, the Board established the Committee for the "purpose of considering and investigating the allegations in" the Demand Letter and making a recommendation to the Board.[14] The Committee consists of James D. Weddle, Shirley Ann Jackson and Gary H. Stern, all members of the Board.[15] The Board authorized the Committee to "exercise such corporate powers and authority necessary or appropriate to fulfill the responsibilities granted or assigned to the Committee[.]"[16] Mr. Weddle agreed to serve as Chairman of the Committee.[17]

III. THE INVESTIGATION PROCESS

Over the course of seven months, the Committee conducted a thorough investigation of the matters raised by the Demand. The Committee reviewed the Demand Letter. It engaged counsel, C. Barr Flinn of Young Conaway Stargatt & Taylor, assisted by his colleague Richard J. Thomas. During the first meetings of the Committee and during subsequent meetings, counsel advised the Committee on the law applicable to the claims proposed in the Demand Letter. Throughout the investigation, the Committee met telephonically, generally on a weekly basis,

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12 Demand Letter at 1-2.

13 Demand Letter at 1-2.

14 02/10/10 Board Minutes at 2.

15 Dr. Jackson joined the Board in August 2007. Mr. Weddle joined the Board in June 2009. Mr. Stern joined the Board in October 2009.

16 02/10/10 Board Minutes at 2.

17 03/04/10 Demand Cmte. Minutes at 1.

with counsel and at least two members of the Committee and frequently with all members present.

During the weekly Committee meetings, the Committee discussed and evaluated the information being accumulated as the investigation proceeded, determined future areas for inquiry and directed counsel on further steps to be taken, including additional documents and interviews to be requested. On July 13, 2010, in New York City, the Committee held a half-day meeting in person, with counsel present, to discuss in detail the information obtained to date, the status of the investigation and the law applicable to the claims proposed in the Demand Letter and to determine additional steps to be taken to complete the investigation.

At the outset of the investigation, FINRA provided the Committee with numerous documents. During the course of the investigation, the Committee periodically requested and obtained additional documents principally from FINRA, but also from other parties. Counsel reviewed the documents that it and the Committee considered material to the investigation. The members of the Committee personally reviewed thousands of pages of documents.

The documents reviewed by the Committee and/or counsel included, among other documents, (1) corporate documents and committee charters, (2) minutes and "kits" for meetings of the Board, Finance Committee, Investment Committee, Compensation Committee and Ad Hoc Investment Committee, (3) questionnaires completed by members of the Board, (4) presentations and reports prepared by FINRA's staff, including the Investment Office, (5) presentations and reports prepared by investment and compensation advisors, (6) Investment Policy Statements, (7) Compensation Philosophies, (8) financial reports and portfolio

performance reports, (9) tax information, (10) various emails between members of the Investment Committee and FINRA management and (11) employment contracts.[18]

During the course of the investigation, the Committee and counsel also interviewed fourteen individuals. The persons interviewed included members of the Ad Hoc Investment Committee, Investment Committee, Compensation Committee and Board. The Committee also interviewed current and former members of FINRA's management. The Committee also interviewed representatives of FINRA's investment advisors, Jeffrey Slocum & Associates, Inc. ("Slocum") and Ennis Knupp & Associates, Inc. ("EnnisKnupp"), and FINRA's compensation consultant, Mercer LLC ("Mercer"). Some or all of the members of the Committee were present by telephone for every interview but one. The interviews were led by counsel, who were present in person, with the exception of the telephonic interview of James Burton, with members of the Committee also asking questions. The interviews generally involved approximately a half-day of questioning. During the Committee's weekly meetings, any Committee member who was not present for the interviews conducted since the last meeting was apprised, by counsel and the other Committee members, of the substance of any interviews he or she had missed. The persons interviewed and the dates and locations of the interviews are as follows:

[18] During the investigation, the Committee also sought further input from Amerivet. At the Committee's request, counsel for the Committee met with counsel for Amerivet in New York City on May 12, 2010. Before and during the meeting, counsel for the Committee requested that Amerivet provide any information that Amerivet believed relevant to the investigation. In response, Amerivet did not provide such information. It did provide the Committee with a list of concerns about FINRA's transparency, oversight and governance. The Committee forwarded the list of concerns to the chairman of the Executive Committee of the FINRA Board.

INTERVIEWEE	CAPACITY	DATE	LOCATION	PRESENT FOR COMMITTEE
Richard Ennis	Representative of EnnisKnupp, FINRA's Current Investment Advisor	05/06/10	Chicago, IL	Stern, Flinn, Thomas
John Brennan	Ad Hoc Investment Committee Member, Current Member of Board, Finance and Investment Committees	05/11/10	Malvern, PA	Stern, Jackson, Flinn, Thomas
Boris Wessely	Former Chief Investment Officer	05/19/10	Rockville, MD	Stern, Jackson, Flinn, Thomas
Stephen Jarrett	Former Senior Vice President, Human Resources	05/24/10	Washington, DC	Thomas
Steve Brown	Representative of Mercer, FINRA's Current Compensation Advisor	05/25/10	New York, NY	Weddle, Flinn, Thomas
Scott Malpass	Current Member of Investment Committee	05/27/10	South Bend, IN	Stern, Flinn, Thomas
William Heyman	Current Member of Board, Investment and Compensation Committees	06/01/10	New York, NY	Weddle, Jackson, Stern, Flinn, Thomas
Janet DenUyl	Representative of Mercer, FINRA's Current Compensation Advisor	06/29/10	Washington, DC	Weddle, Flinn, Thomas
Todd Diganci	Current Chief Financial Officer	07/08/10	Washington, DC	Weddle, Stern, Flinn, Thomas
Meggan O'Shea	Representative of Slocum, FINRA's Former Investment Advisor	07/20/10	Minneapolis, MN	Stern, Flinn, Thomas
Kurt Stocker	Current Member of Board and Compensation Committee; Former Member of Investment Committee	07/21/10	Chicago, IL	Stern, Flinn, Thomas
Ellyn Brown	Current Member of Board and Compensation Committee	07/27/10	Wilmington, DE	Weddle, Stern, Flinn, Thomas
James Burton	Current Member of Board, Finance and Investment Committees	08/04/10	Sacramento, CA (by phone)	Stern, Flinn, Thomas
Richard Brueckner	Current Member of Board, Finance and Investment Committees	08/16/10	Jersey City, NJ	Weddle, Flinn, Thomas

The Committee is not aware of any information, other than the information that it obtained during the investigation, that would be material to the investigation or the recommendations made in this report. The Committee has been provided with all the documents that it requested. It also has obtained all the interviews that it requested, with one exception: It

requested an interview of KC Connors, a former employee of Slocum, one of FINRA's investment advisors. Ms. Connors initially declined to provide an interview. As an alternative, the Committee requested and obtained an interview of a current employee of Slocum, Meggan O'Shea. Upon completing the interview with Ms. O'Shea, the Committee concluded that it had obtained sufficient information concerning Slocum's involvement in the events under investigation and that an interview of Ms. Connors likely would provide only duplicative information. The Committee therefore withdrew its request to interview Ms. Connors.

The Committee has determined that the information it obtained during the course of the investigation is more than sufficient for the Committee to complete its investigation and make the recommendations in this report.

RESULTS

The results of the investigation are presented below in two parts. The first part addresses possible claims concerning the 2008 investment losses. The second part addresses possible claims concerning the compensation paid to senior management in 2007, 2008 and 2009.

PART ONE:
CLAIMS FOR 2008 INVESTMENT LOSSES

This part of the report is divided into six sections. Section I provides background on the 2008 investment losses, identifies the endowment decision as the primary cause of the losses, aside from market forces, and identifies the persons responsible for the decision. Section II addresses potential claims for breach of the fiduciary duty of loyalty against the members of the Board, Finance Committee and Investment Committee for making the endowment decision. Section III addresses potential claims for breach of the fiduciary duty of good faith against the same persons for making the same decision. Section IV addresses potential claims for breach of the fiduciary duty of care against the same persons. Section V addresses potential claims for breach of fiduciary duty against the same persons based on the decisions they made to implement the endowment decision. Section VI addresses potential claims concerning the investment losses against (1) Scott Malpass and Richard Romano, two members of the Investment Committee who were not governors of FINRA, (2) members of management, (3) Jeffrey Slocum & Associates, FINRA's financial advisor and (4) legal counsel for FINRA. [19]

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[19] The Committee was advised by counsel that breach of fiduciary duty and negligence claims generally will be time barred in Delaware, New York and Washington, D.C., the states whose courts would be most likely to have jurisdiction over the individuals investigated, if they are asserted more than three years after the occurrence of the decisions or actions giving rise to the claims. 10 Del. C. § 8106; N.Y. C.P.L.R. 214; D.C. Code § 12-301. The Committee was informed that while Minnesota, the state in which Jeffrey Slocum & Associates is headquartered, has a general six-year limitation period for negligence claims brought by Minnesota residents, *see* Minn. Stat. § 541.05, a Minnesota court

I. BACKGROUND

A. Description of the Losses

As of December 31, 2003, FINRA's investment portfolio was invested 80% in fixed-income and cash/cash equivalents and 20% in equity. Its market value stood at $1.2 billion. The following year, FINRA began to implement its decision to invest in the manner of a diversified endowment. As of December 31, 2005, the portfolio was invested as follows: 20% in fixed-income, 48% in equity, 15% in absolute return strategies, 4% in emerging markets, 7% in real estate and 6% in real assets. During the four years following December 31, 2003, the portfolio produced a total return of $616

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likely would apply the limitations period of the state whose law governs the negligence claim if FINRA, a non-resident, pursued a negligence claim against Slocum in Minnesota. *See* Minn. Stat. § 541.31 (for a non-resident plaintiff, where a "claim is substantively based...upon the law of one other state, the limitations period of that state applies").

The Committee was advised that the courts may treat a limitations period as tolled, with the result that it does not begin to run, to the extent that the plaintiff asserting the claim lacked certain information concerning the claim when the claim first arose. Under such circumstances, the limitations period would be tolled during the time that the plaintiff lacked the information. The Committee does not believe that the limitations period would be tolled for claims based upon pre-August 2007 decisions to invest as a diversified endowment because the rationale for investing as a diversified endowment and the resulting asset allocations were disclosed in FINRA's 2006 Annual Report, which was made available to members more than three years ago. *See Albert v. Alex. Brown Mgmt. Servs*, 2005 Del. Ch. LEXIS 100, at *65–*67 (Del. Ch. June 29, 2005) (holding that investor reports detailing the types of securities held by funds gave plaintiffs notice of a potential claim based upon an alleged failure to properly diversify the investments of the funds).

In reaching the conclusions set forth in this report, the Committee has taken into consideration that FINRA may not be able to prevail on breach of fiduciary duty or negligence claims based upon decisions made or actions taken before August 2007, even it the claims might otherwise have merit. Nonetheless, the Committee has investigated potential claims dating back to 2002. It has done so for thoroughness and because the events that occurred within the limitations period and that might support a claim that is not time barred are best understood in the context of the preceding events.

million and grew to a market value of $2 billion by December 31, 2007.[20] As of that date, FINRA's funds were invested as follows: 17.9% in fixed-income, 45.7% in equities, 20.7% in marketable alternatives, 12.5% in real assets and 3.2% in private equity.

During 2008, the portfolio gave up most of its prior gains, incurring losses of $567 million or 26.5%.[21] In 2009, the portfolio again provided gains, posting a return of $203.8 million, with the result that the market value of the portfolio stood at $1.59 billion on December 31, 2009. From December 31, 2003 to December 31, 2009, the portfolio produced a total net return, net of the 2008 losses, of $252 million.[22]

B. Cause of the Losses

The Committee has concluded that, to the extent that any decision by FINRA, as opposed to simply market forces, contributed to the investment losses, it was principally the decision to invest in the manner of a diversified endowment. However reasonable or even optimal this decision may have been as a strategy for the long term, it nonetheless exposed the portfolio to greater short-term volatility, particularly during the unusual market conditions prevailing during the latter months of 2008. The Committee does not believe that any substantial portion of FINRA's 2008 investment losses would have been avoided if FINRA had invested in the manner of a diversified endowment, but made different investments with the same permitted asset classes. The Committee's investigation therefore has focused closely on the decision to invest in the manner of a diversified endowment. As detailed below, the decision to invest in the manner

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[20] FINRA Investment Since Inception Analysis, attached to this report as Exhibit A.

[21] FINRA Investment Since Inception Analysis, Ex. A.

[22] FINRA Investment Since Inception Analysis, Ex. A. During this same time period, the portfolio was used to support $293 million of FINRA's budget and to provide $326.5 million of rebates to members. *See id.*

of an endowment was made in 2003, reconsidered in 2006 and reconsidered again in September 2008.

The same conclusion reached by the Committee about the decision most responsible for the losses incurred during the 2008 market decline was also reached by members of the Investment Committee and management who were interviewed by the Committee. They generally agreed that, aside from market forces, the asset allocations were the primary cause of the investment losses and that once the decision was made to invest using asset allocations typical of college endowments, the investment losses were inevitable when the markets declined generally.

The Committee's conclusion is also supported by the actual performance of the portfolio during the market decline. During the 2008 decline, the portfolio performed very much like the college endowments that it was designed to emulate. For the year ended June 30, 2009, the market value of the FINRA portfolio declined 18.5% as compared to a decline of 19.1%, the median performance for foundations and endowments reported by the Wilshire Trust Universe Comparison Service.[23]

C. Responsibility for Allocation and Other Decisions

Pursuant to the committee charters for the FINRA Board, responsibility for determining the asset classes in which the available funds should be invested and the percentage of the funds that should be invested in each class remained with the full Board. The asset allocations were

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[23] Data gathered from American colleges and universities participating in the 2009 NACUBO-Commonfund Study of Endowments similarly showed that the endowments of these entities lost an average of 18.7% for the year ended June 30, 2009. *See* Press Release, NACUBO-Common Fund Study of Endowments, Educational Endowments Returned -18.7% in FY 2009 (Jan. 28, 2010) (available at http://www.nacubo.org/Documents/research/2009_NCSE_Press_Release.pdf).

embodied in FINRA's Investment Policy Statement, which was periodically reviewed and amended by the Board. The Finance Committee however was responsible for recommending asset allocations to the Board.[24] And the Investment Committee in turn was responsible for recommending asset allocations to the Finance Committee.[25]

Decisions as to how to implement the asset allocations were delegated to the Finance Committee,[26] except that after April 2007, after FINRA had hired a chief investment officer and established an internal Investment Office, decisions concerning the selection of investment managers were delegated to the Investment Committee and the Investment Office, with the Investment Committee responsible for decisions on the more illiquid investments and the Investment Office responsible for making decisions on the more liquid investments.[27]

During the relevant time period, at almost every meeting of the Finance Committee, a representative of the Investment Committee provided the Finance Committee with a report of the usually immediately proceeding meeting of the Investment Committee. This was apparently for the benefit of the few Finance Committee members who were not also members of the Investment Committee. Also, during the relevant time period, at almost every meeting of the Board, a representative of the Finance Committee provided the Board with a report of the prior meeting of the Finance Committee. In this manner, all members of the Board were kept apprised of significant decisions made concerning the investment portfolio.

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24 2008 Fin. Cmte. Charter; 2003 Fin. Cmte. Charter.

25 2008 Invest. Cmte. Charter, 2003 Invest. Cmte. Charter.

26 2005 IPS at 3; 2004 IPS at 3.

27 2007 IPS at 3-4.

II. PROPOSED CLAIMS FOR BREACHES OF THE FIDUCIARY DUTY OF LOYALTY

A. Applicable Law

The Committee was advised as follows concerning the law applicable to a claim for breach of the fiduciary duty of loyalty, putting aside issues of good faith, which are addressed separately below. To prevail on a claim that a decision or inaction of the Board, Finance Committee or Investment Committee constituted a breach of the duty of loyalty, FINRA must first establish that, at the relevant time, a "majority of the [Board, Finance Committee or Investment Committee] was interested or lacked independence with respect to the" matter in question.[28]

The personal interest must be an interest in the matter that is not equally shared with FINRA's members generally.[29] Even if such an interest exists, "to be disqualifying, the nature of the...interest must be substantial," and not merely "incidental."[30] Alleging that a director

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28 *In re Trados Inc. S'holder Litig.*, 2009 Del. Ch. LEXIS 128, at *39-40 (Del. Ch. July 24, 2009). *See also Official Comm. of Unsecured Creditors of Integrated Health Servs. v. Elkins*, 2004 Del. Ch. LEXIS 122, at *35 (Del. Ch. Aug. 24, 2004) (explaining that, in evaluating a breach of fiduciary duty claim, the court must determine whether the "Board that approved each Challenged Transaction consisted of a majority of members not interested in the Challenged Transaction or not beholden to one who was interested in the Challenged Transaction.").

The Committee was advised that if the above majority interest or lack of independence were established, FINRA would also need to establish that the decision or inaction was less than entirely fair to FINRA. The Committee was also informed that if it were to determine that a minority of the members of the Board, Finance Committee or Investment Committee had a material interest or lacked independence, further analysis would be necessary to determine whether that interest/lack of independence was disclosed to the other members of the Board or committee. *See* 8 *Del. C.* § 144.

29 *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993).

30 *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1169 (Del. 1995).

"received [a] benefit not equally shared by the stockholders" is "not enough[.]"[31] The personal interest must be of "a sufficiently material importance, in the context of" the "economic circumstances" of the member of the Board, Finance Committee or Investment Committee as to make it "improbable that the [member] could perform her fiduciary duties" to FINRA's members "without being influenced by her overriding personal interest[.]"[32] Relevant material interests include circumstances in which an alternative decision would have a "materially detrimental impact" on the member of the Board, Finance Committee or Investment Committee such that he or she could not be expected to "exercise his or her independent business judgment without being influenced by the adverse personal consequences resulting from the decision."[33]

With respect to the independence inquiry, the lack of independence must arise from "financial ties, familial affinity [or] a particularly close or intimate personal or business affinity" to someone who was interested in the decision or inaction[34] that renders the member of the Board, Finance Committee or Investment Committee "more willing to risk his or her reputation than risk the relationship with the interested" person.[35] "Mere allegations that they move in the same business and social circles, or a characterization that they are close friends, is not enough to negate independence[.]"[36]

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[31] *Orman v. Cullman*, 794 A.2d 5, 23 (Del. Ch. 2002).

[32] *In re GM Class H Shareholders Litig.*, 734 A.2d 611, 617 (Del. Ch. 1999).

[33] *Rales*, 634 A.2d at 936.

[34] *Beam v. Stewart*, 845 A.2d 1040, 1051-1052 (Del. 2004).

[35] *Id.*

[36] *Id.*

B. Relevant Facts

The Committee examined the interests and relationships of those members of the Board, Finance Committee and Investment Committee who made and revisited the decision to invest in the manner of a college endowment. Those members are listed in the table below, along with the decisions that they recommended and/or approved:

Decision	Ad Hoc Committee	Investment Committee	Finance Committee	Board	
2003 Endowment Decision	Brennan Corby Meyer Romano Sherr	Brennan Brueckner Burton Corby Glauber	Alsover Boglioli Brennan Brueckner Burton Corby DeMuro Glauber Isenberg	Alsover Bachmann Bakerink Boglioli Borders Bowsher Brennan Brueckner Burton Corby DeMuro	Duberstein Glauber Isenberg Kamen Kelly Mason Romano Schapiro Simmons Smith Sodano
2005 Asset Allocation Revision	N/A	Brennan Burton Corby Heyman Malpass Romano	Alsover Brennan Brueckner Burton Corby DeMuro Glauber Rutherfurd	Alsover Bachmann Bakerink Bowsher Brennan Brueckner Burton Corby DeMuro	Duberstein Glauber Heyman Mason Rutherfurd Schapiro Seligman Shea Smith
2006 Endowment Decision Revisitation	N/A	Brennan Burton Corby Heyman Malpass Romano	Alsover Brennan Brueckner Burton Corby Glauber Rutherfurd Simmers	Alsover Bachmann Bowsher Brennan Brueckner Burton Corby Dedman Glauber	Heyman Kovack MacDonald Mason Rutherfurd Schapiro Seligman Simmers Smith

2008 Endowment Decision Revisitation	N/A	Brennan Brueckner Burton Corby Heyman Malpass Romano Stocker	Finance Committee Informed that Investment Committee In Process of Reviewing	Board Informed that Investment Committee In Process of Reviewing

All persons interviewed by the Committee who were involved in FINRA's investments were asked whether they knew of anything that might possibly suggest that any of these individuals had any personal interest, different from that of FINRA's members generally, in the decision to invest like a college endowment and/or in revisiting that decision. They were also asked whether they knew of anything suggesting that any member was beholden to or otherwise lacked independence from a person who had such an interest. Those interviewed uniformly responded in the negative or raised the issues addressed in the footnote below, which the Committee has concluded do not approach material interests or lack of independence in the endowment decision.[37]

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[37] FINRA made some investments through Western Assets, a fixed-income manager wholly owned by Legg Mason, of which Raymond "Chip" Mason (a Board member of FINRA in 2003 and 2006 when the decision to invest in the manner of an endowment was made and reconsidered) was chairman, president and chief executive officer. Mr. Mason was not involved in the selection of Western Assets.

James Burton, who has served on the Board, Finance Committee and Investment Committee since 2001, was the chief executive of the World Gold Council, the marketing arm for the gold mining industry, from 2002 to 2008. He created for the World Gold Council an exchange-traded gold fund in which FINRA invested $10.5 million. Mr. Burton recused himself from any discussion or decision relating to that investment. 12/01/05 Fin. Cmte. Minutes at 3; 11/30/05 Invest. Cmte. Minutes at 1-2.

The Committee discussed the possibility that Mr. Mason supported the decision to invest in the manner of a college endowment with the expectation that FINRA might later decide to invest through a subsidiary of his company. The Committee also discussed the possibility that Mr. Burton supported the

The Committee and/or its counsel also has reviewed the governor questionnaires in which governors provide background about themselves that may be used to identify potential conflicts. The questionnaires showed no potential personal interests in the endowment decision. The Committee and counsel considered known business affiliations of the relevant persons. Such affiliations did not raise any issues concerning the disinterest of and/or independence of such persons. The Committee and/or its counsel reviewed the email correspondence among members of the Investment Committee and management. They did not reflect any interests in the endowment decision.

C. <u>Conclusion</u>

Based upon the above, the Committee does not believe that FINRA has a genuine basis to assert that any member of the Board, Finance Committee or Investment Committee was interested in the endowment decision or lacked independence from a person who had such an interest. In reaching this conclusion, the Committee has taken into consideration the unlikelihood that any member of the Board, Finance Committee or Investment Committee could have anticipated any specific benefit to him or herself, or any entity with which he or she was affiliated, from a decision as generalized as the decision to invest in broadly-defined asset classes.

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endowment decision with the expectation that FINRA might invest in gold. Based upon its investigation, the Committee is satisfied that Messrs. Mason and Burton did not, in approving the endowment decision, take into consideration the possibility that FINRA might later invest through Western Assets or in gold. The Committee further concludes that potential future investments through Western Assets or in gold could not plausibly have been material considerations to Messrs. Mason and Burton in their consideration of whether FINRA should invest in the manner of an endowment.

The Committee therefore has concluded that FINRA does not have a genuine basis to assert claims for breaches of the fiduciary duty of loyalty.

III. PROPOSED CLAIMS FOR BREACH OF THE FIDUCIARY DUTY OF GOOD FAITH

A. Applicable Law

The Committee was advised as follows concerning the law applicable to claims that the members of the Board, Finance Committee and/or Investment Committee breached their duties of good faith in making the endowment decision. The duty of good faith is an aspect of the duty of loyalty. To prevail on a claim for breach of the duty of good faith, FINRA must establish that a majority of the members of the Board, Finance Committee or Investment Committee intentionally failed "'to act in the face of a known duty to act, demonstrating a conscious disregard'" for their duties.[38] Alternatively, FINRA might prevail on such a claim by showing that a majority acted "'with a purpose other than that of advancing the best interests'" of FINRA or "'with the intent to violate applicable'" law.[39]

The Delaware Court of Chancery recently addressed the issue of good faith and other fiduciary duties in the context of director decisions about the appropriate level of investment risk for the corporation. It explained the deference that courts give to such decisions:

> The essence of the business judgment of managers and directors is deciding how the company will evaluate the trade-off between risk and return. Businesses – and particularly financial institutions – make returns by taking on risk; a company or investor that is willing to take on more risk can earn a higher return. Thus, in

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38 *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006) (*quoting Brehm v. Eisner (In re Walt Disney Co. Derivative Litig.)*, 906 A.2d 27, 67 (Del. 2006)).

39 *Id.* (*quoting In re Walt Disney*, 906 A.2d at 67). The Committee was further advised that a poor decision-making process, even if grossly negligent, alone would be insufficient to support a conclusion that the decision-maker acted in bad faith. *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 240 (Del. 2009).

> almost any business transaction, the parties go into the deal with the knowledge that, even if they have evaluated the situation correctly, the return could be different than they expected.
>
> It is almost impossible for a court, in hindsight, to determine whether the directors of a company properly evaluated risk and thus made the "right" business decision. In any investment there is a chance that returns will turn out lower than expected, and generally a smaller chance that they will be far lower than expected. When investments turn out poorly, it is possible that the decision-maker evaluated the deal correctly but got "unlucky" in that a huge loss – the probability of which was very small – actually happened. It is also possible that the decision-maker improperly evaluated the risk posed by an investment and that the company suffered large losses as a result.
>
> Business decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future. To impose liability on directors for making a "wrong" business decision would cripple their ability to earn returns for investors by taking business risks.[40]

B. <u>Relevant Facts</u>

Based upon the above advice, the Committee sought to determine whether, in making the endowment decision and later in not reversing it, the members of the Board, Finance Committee or Investment Committee demonstrated a "conscious disregard for their duties" or "acted with a purpose other than that of advancing the best interests" of FINRA and its members.[41] To make this determination, the Committee thoroughly investigated the steps taken by the members of the Board, Finance Committee and Investment Committee in determining the appropriate investment strategy. The following is a lengthy description of such steps.

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[40] *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 126 (Del. Ch. 2009).

[41] *Stone*, 911 A.2d at 369 (*quoting In re Walt Disney*, 906 A.2d at 67).

1. Receipt of NASDAQ Proceeds

In April 2000, FINRA's members approved a plan to sell FINRA's equity interest in NASDAQ to a variety of investors. FINRA began receiving proceeds from the sale during the years 2001 and 2002. During that time, Todd Diganci, FINRA's chief financial officer, and James Allen, FINRA's treasurer, were responsible for managing FINRA's investments, subject to oversight by the Investment Committee. In 2002, approximately 82% of FINRA's portfolio was invested in fixed-income securities and cash/cash equivalents and 18% was invested in equities.[42]

As FINRA received proceeds from the NASDAQ sale and the portfolio grew to approximately $1 billion by the end of 2002, FINRA's chief executive officer, Robert Glauber, was discussing with FINRA's members alternative future uses for the proceeds. Some members wanted FINRA to distribute the proceeds to members.

2. 2003 Board Approval of the Endowment Approach

a. The Recommendation of the Ad Hoc Investment Committee

i. Creation of the Ad Hoc Investment Committee

To help answer questions about the best use of the NASDAQ proceeds, management recommended the formation of an Ad Hoc Investment Committee to study the issue. The Investment Committee agreed with management and recommended that the Finance Committee recommend the establishment of such a committee.[43] The Finance Committee agreed and made such a recommendation to the Board, which established the Ad Hoc Investment Committee on April 24, 2003. The Board stated that the purpose of the Ad Hoc Investment Committee was to advise the Finance and Investment Committees on (1) the levels at which FINRA's reserves

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[42] 08/31/02 Performance Report.

[43] 04/14/03 Invest. Cmte. Minutes at 1.

should be maintained, (2) the use of reserves deemed to be in excess of prudent levels and (3) FINRA's investment policy and objectives.[44]

The membership of the Ad Hoc Investment Committee was designed to include individuals who were not members of the Board but had expertise in different areas of investing. It was also designed to reflect the diversity of FINRA membership. Jack Brennan of The Vanguard Group had expertise on mutual funds, while Jack Mayer of Harvard Management Company was an expert on endowments. Richard Romano specialized in fixed-income investments. Additionally, Mr. Romano and Carl Sherr acted as advocates for smaller firms; both initially supported the notion that the NASDAQ proceeds should be paid to the members. Sir Brian Corby, the retired Chairman of Prudential Corporation, was appointed the chairman of the Ad Hoc Investment Committee and led the Committee through its process.

When the Ad Hoc Investment Committee was organized, FINRA's investment assets were valued at just under $1 billion.[45] These assets were separated into three fund groupings: operating reserves, short-term reserves, and long-term reserves.[46] The overall investment objective had been to "blend the 3 groupings to satisfy [FINRA's] needs for liquidity, income, and the maintenance of purchasing power[.]"[47] At the time, FINRA's assets were allocated as follows:[48]

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44 04/24/03 Board Minutes at 7.

45 05/12/03 Investment Reserves Presentation at 2.

46 05/12/03 Investment Reserves Presentation at 2.

47 05/12/03 Investment Reserves Presentation at 3.

48 05/12/03 Investment Reserves Presentation at 3.

Allocations	Market Value ($Millions)	% of Portfolio	Target
Operating – Cash & Equivalents	121	13%	18%
Short-Term Reserves – Fixed-Income	329	34%	30%
Long-Term Reserves – Fixed-Income	331	34%	30%
Long-Term Reserves – Equities	184	19%	22%
Total Investments	964	100%	100%

The targets were designed to produce an absolute return of 7% and a real return of 3%.[49] Between 2000 and 2003, the portfolio had a 5.25% annualized return.[50]

ii. Ad Hoc Investment Committee Process

After the members of the Ad Hoc Investment Committee were chosen, each met with Sir Brian Corby to discuss, among other topics, the appropriate levels of reserves, the perception that FINRA was over-funded, the size and nature of FINRA's revenues/budget, return objectives, the distribution of excess reserves and the benefits and disadvantages of various investment strategies.

The Ad Hoc Investment Committee members agreed that the first issue to discuss was the reasons for FINRA to maintain reserves. They discussed the minimum reserves of $500 million previously endorsed by the Fairness Committee and recommended by the SEC in 1999 in connection with FINRA's planned divestiture of NASDAQ,[51] the need for reserves to cover unfunded mandates, uncertainty about the future, the correlation of FINRA's revenue with trading activity, member rebates and FINRA's anticipated annual spending needs.[52] They also discussed FINRA's role as a regulator and the perception by members that FINRA was over-

49 05/12/03 Investment Reserves Presentation at 3.

50 05/12/03 Investment Reserves Presentation at 3.

51 2003 Ad Hoc Cmte. Report at 2.

52 06/27/03 Key Discussion Points: Ad Hoc Cmte. at 2.

funded.[53] The Ad Hoc Investment Committee had frank and robust discussions about the purpose of FINRA's investments and how to maintain their purchasing power. The process took more time than at least some of the members had originally anticipated.

iii. Information Provided to the Ad Hoc Investment Committee

Sir Brian Corby began the Ad Hoc Investment Committee process by circulating a "kit of materials to orient each of [the members] to the responsibilities of the Committee, including background information on [FINRA's] Investment Policy and Guidelines and current investment issues and constraints that are relevant to the Committee's charter."[54] The Ad Hoc Investment Committee members also received an executive summary of investment performance[55] and long-term projections so that they could "understand the current uses of cash as well as the future cash flows" of FINRA.[56]

During its meetings, the Ad Hoc Investment Committee "reviewed and evaluated a broad range of relevant information including various analyses of [FINRA's] investment policy and reserves, existing and potential financial constraints, long-term projections, industry best practices, and risk/return objectives within an asset allocation framework."[57] Mr. Meyer, with the assistance of his team at Harvard, ran models and showed what the volatility and expected returns of proposed investment strategies would be. Concord Advisors, FINRA's investment consultant at the time, provided advisory service and gave regular reports to the Ad Hoc Investment Committee about the existing portfolio. FINRA's management provided the Ad Hoc

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53 06/27/03 Key Discussion Points: Ad Hoc Cmte. at 3.

54 05/21/03 Memo from B. Corby to Ad Hoc Cmte.

55 05/20/03 Memo from L. Rubinstein to Ad Hoc Cmte. at 1.

56 05/29/03 Memo from T. Diganci to Ad Hoc Cmte. at 1.

57 10/15/03 Ad Hoc Cmte. Report at 1.

Investment Committee with information about FINRA's investment activities, working capital needs, operating budget (and the spending from the investment portfolio needed to support the budget), potential target asset allocations (for which projections were prepared with the assistance of Concord) and other financial information.

iv. Ad Hoc Investment Committee Recommendations

After reviewing and discussing the information it had received, the Ad Hoc Investment Committee unanimously recommended that FINRA retain the proceeds of the NASDAQ sale and invest them, for the benefit of members and with a long-term horizon, in asset classes and with allocations to each asset class that were similar to college endowments.[58] The Ad Hoc Investment Committee also "embrace[d] the policy of continued member rebates and/or reductions in member assessments which may be possible as a result of positive financial results, subject to the constraints of the inurement doctrine."[59]

The Ad Hoc Investment Committee reviewed and discussed the following table, which showed FINRA's current asset allocations and potential alternative allocations:

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58 10/15/03 Ad Hoc Cmte. Report at 2; 07/09/03 Ad Hoc Cmte. Minutes at 1.

59 10/15/03 Ad Hoc Cmte. Report at 4.

CURRENT AND PROPOSED ASSET ALLOCATIONS JULY 29, 2003							
	Current	Greenwich Endowments ($500M-1B)	Typical Endowment	25 Largest Endowments	Harvard	Proposed Allocation #1	Proposed Allocation #2
US Equities	15.0%	44.1%	48.0%	32.0%	15.0%	30.0%	35.0%
Foreign Equities	4.0%	13.4%	14.0%	11.0%	10.0%	10.0%	10.0%
Emerging Markets	0.0%	0.0%	2.0%	3.0%	5.0%	5.0%	5.0%
Private Equities	0.0%	5.2%	4.0%	12.0%	13.0%	10.0%	10.0%
Total	19.0%	62.7%	68.0%	58.0%	43.0%	55.0%	60.0%
Absolute Return	0.0%	6.2%	3.0%	13.0%	12.0%	10.0%	2.5%
High-Yield	0.0%	0.0%	2.0%	3.0%	5.0%	3.0%	2.5%
Commodities	0.0%	0.0%	2.0%	3.0%	13.0%	0.0%	0.0%
Real Estate	0.0%	2.8%	3.0%	5.0%	10.0%	5.0%	5.0%
Total	0.0%	9.0%	10.0%	24.0%	40.0%	18.0%	10.0%
US Bonds	68.0%	26.1%	20.0%	13.0%	11.0%	19.0%	19.0%
Foreign Bonds	0.0%	0.0%	0.0%	2.0%	5.0%	3.0%	3.0%
Inflation Indexed	0.0%	0.0%	0.0%	1.0%	6.0%	3.0%	5.0%
Cash	13.0%	2.2%	2.0%	2.0%	-5.0%	2.0%	3.0%
Total	81.0%	28.3%	22.0%	18.0%	17.0%	27.0%	30.0%
	100%	100%	100%	100%	100%	100%	100%
Real Return	3.38%	5.07%	5.21%	5.35%	5.42%	5.12%	5.14%
Standard Deviation	6.22	10.33	10.82	9.78	7.92	9.29	9.50
Sharpe Ratio	0.30	0.35	0.34	0.39	0.49	0.39	0.38

The Ad Hoc Investment Committee endorsed Proposed Allocation #1.[60] It also noted that the portfolio transition would likely take two to three years to implement.[61]

The Ad Hoc Investment Committee concluded that investment by FINRA in equity securities in general, and NASDAQ listed equities in particular, would "not pose either legal or conflict issues."[62] The Ad Hoc Investment Committee did however decide that FINRA should

60 07/29/03 Ad Hoc Cmte. Minutes at 1.

61 07/29/03 Ad Hoc Cmte. Minutes at 1.

62 10/15/03 Ad Hoc Cmte. Report at 2.

continue to prohibit investments in member firms or in holding companies deriving 25% or more of their revenues from the activities of a member or its subsidiaries or affiliates.[63] The Ad Hoc Investment Committee understood and agreed that it was essential that FINRA "be perceived as absolutely devoid of any conflicts of interest."[64]

The Ad Hoc Investment Committee discussed creating a spending rule with implications for the budget that would help support the cost of regulation and provide tangible evidence of benefits to members.[65] The Ad Hoc Investment Committee recommended a spending rule target of 5% in real terms (4% during a transitionary period) based on the market value of the portfolio using a three-year rolling market average.[66]

In its final report, the Ad Hoc Investment Committee recommended that FINRA: (1) "retain its accumulated reserves and invest those reserves as an endowment with a long-term time horizon"; (2) retain "reserves in excess of those needed for working capital purposes, with a minimum level of $500 million"; (3) adopt a "spending rule target and real return objective for the endowment of 5%"; (4) adopt a diversified portfolio based on allocations to equities (55%-60%), fixed income (25%-30%), and alternative investments (15%-20%); (5) restructure the Investment Committee to have a "wider representation including industry and professional endowment investment expertise"; (6) develop a communications plan to "fully inform members about the endowment" and (7) create an "action plan for implementation over a prudent strategically determined timeframe."[67] The Ad Hoc Investment Committee also recommended

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63 10/15/03 Ad Hoc Cmte. Report at 6.

64 10/15/03 Ad Hoc Cmte. Report at 6.

65 07/09/03 Ad Hoc Cmte. Minutes at 1.

66 10/15/03 Ad Hoc Cmte. Report at 5.

67 10/15/03 Ad Hoc Cmte. Report at 1-3.

that FINRA "increase its current allocations to high yield and emerging market debt, and initiate modest allocations to absolute return strategies, which aim to deliver returns in both rising and falling markets, and to real estate."[68]

v. The Rationale of the Ad Hoc Investment Committee

The Ad Hoc Investment Committee's recommendation that FINRA retain the NASDAQ proceeds, rather than distribute them to members, was based on several considerations. First, FINRA's tax counsel, Davis Polk & Wardwell, advised that FINRA's non-profit status prevented the proceeds from being distributed to members in an amount greater than that received from each member.[69] Second, if FINRA in 2003 had rebated all of the fees paid by members, a small minority of FINRA's members, consisting of the largest members, would have received the vast majority of the proceeds. Third, the Ad Hoc Investment Committee recognized that FINRA could invest the NASDAQ proceeds on a tax-free basis while members (if the proceeds were given to them) could not.[70] Fourth, FINRA's retention of the proceeds would reduce member fees and avoid increases in member fees during difficult economic times.[71] Finally, retention of

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[68] 10/15/03 Ad Hoc Cmte. Report at 5.

[69] 10/15/03 Ad Hoc Cmte. Report at 1; 07/09/03 Ad Hoc Cmte. Minutes at 1.

[70] 10/15/03 Ad Hoc Cmte. Report at 1, 3 ("The ability to invest such funds on a tax-exempt basis should yield higher returns to help maintain NASD's financial position.").

[71] 10/15/03 Ad Hoc Cmte. Report at 1, 3 ("[T]he regulatory environment is in the foreseeable future likely to put increasing pressure on our members and on [FINRA] with potential implications as to costs. While raising the dues or assessments of members is always an option, it is one to be avoided, particularly if it occurred in difficult economic times, which remains a clear possibility. As an alternative, funds invested on a tax-exempt basis could be used to generate significant sums for the operating budget to the benefit of the members."); 07/09/03 Ad Hoc Cmte. Minutes at 1.

the proceeds would protect FINRA from contingencies and unfunded liabilities and fund capital investments.[72]

The Ad Hoc Investment Committee concluded that investing the NASDAQ proceeds in a manner similar to a college endowment would meet the short-term and long-term objectives of FINRA by preserving purchasing power while providing a sustainable level of income to support budget needs. The Ad Hoc Investment Committee also determined that investing like a college endowment would allow FINRA to "more fully diversify [its] investments by introducing asset classes bearing lower risk than traditional equities."[73] It further determined that the "returns from these strategies are not highly correlated with the performance of traditional assets such as common stocks or bonds and tend to be more consistent than these categories."[74] It noted that this was "particularly important for" FINRA, "since its revenues are largely correlated to activity in the equity markets."[75]

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72 Ad Hoc Cmte. Report at 1, 5; 07/09/03 Ad Hoc Cmte. Minutes at 1.

73 10/15/03 Ad Hoc Cmte. Report at 5.

74 10/15/03 Ad Hoc Cmte. Report at 5.

75 10/15/03 Ad Hoc Cmte. Report at 5.

b. Board Approval of the Ad Hoc Investment Committee Report and the Proposed Investment Policy Statement

The Ad Hoc Investment Committee's report was presented to the Investment Committee on October 24, 2003, and the Investment Committee, after discussing the report's analysis and conclusions, "wholeheartedly endorsed its contents" to the Finance Committee,[76] which also endorsed the conclusions.[77] On November 13, 2003, based upon the work of the Ad Hoc Investment Committee, and the recommendation from the Finance and Investment Committees, the Board approved the retention of the NASDAQ proceeds as accumulated reserves and the investment of those reserves in the manner of an endowment with a long-term time horizon.[78]

The Board also approved the Ad Hoc Investment Committee's recommendation to restructure the Investment Committee so that, among other things, it would include "a member with professional endowment expertise" and therefore "produce an appropriate breadth of industry and professional investment expertise to set policy and provide an oversight role for the endowment."[79] As a result of this restructuring, Scott Malpass, the chief investment officer of Notre Dame, joined the Investment Committee.

On January 21, 2004, the restructured Investment Committee reviewed a proposed Investment Policy Statement for FINRA's endowment-style portfolio.[80] It included the

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76 10/24/03 Invest. Cmte. Minutes at 2.

77 11/13/03 Board Minutes at 4.

78 11/13/03 Board Minutes at 4.

79 10/15/03 Ad Hoc Cmte. Report at 6-7.

80 01/21/04 Invest. Cmte. Minutes at 2; 2004 IPS.

following asset allocations, which were nearly the same as the allocations recommended by the Ad Hoc Investment Committee:[81]

2004 INVESTMENT POLICY STATEMENT ASSET ALLOCATIONS		
Asset Class	Allowable Range	Target Allocation
Domestic Equities	25%-35%	30.0%
Foreign Equities	10%-15%	12.5%
Emerging Markets	4%-7%	5.0%
Private Equities	8%-12%	10.0%
Total Equities	50%-65%	57.5%
Domestic Bonds	14%-24%	19.0%
Foreign Bonds	1%-5%	3.0%
Inflation-Indexed	1%-5%	3.0%
Cash	0%-5%	0.0%
Total Fixed Income	20%-30%	25.0%
Absolute Return/Hedge Funds	3%-9%	6.0%
High-Yield/Emerging Market Debt	2%-6%	4.0%
Real Estate	5%-10%	7.5%
Total Alternative Invest.	15%-20%	17.5%
Total		100%

After discussion, the Investment Committee agreed to the proposed asset allocation targets, noting that the percentage allocations could be revisited as the policy was implemented.[82] The Finance Committee and the Board approved the revised Investment Policy Statement, including the proposed asset allocation, on January 22, 2004.[83]

3. Slocum Retained

In light of the size and complexity of FINRA's endowment-style portfolio, FINRA sought a new investment advisor in 2003-2004 to provide advice on policy documentation and

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81 2004 IPS at Apdx. A.

82 01/21/04 Invest. Cmte. Minutes at 2.

83 01/22/04 Fin. Cmte. Minutes at 1; 01/22/04 Board Minutes at 8.

the selection of managers. It was perceived that FINRA's incumbent advisor at the time, Concord, lacked the necessary expertise in alternative investments.[84] Mr. Malpass recommended Jeffrey Slocum and Associates, Inc., which was known for having a strong practice in alternative investments. Slocum and two other finalists were "closely evaluated on six key factors: size of firm and comparable client base, consultant team experience and credibility, research orientation and idea generation, service delivery, alignment with [FINRA] policy, and fees."[85]

After considering the three finalists, management recommended that Slocum be engaged in light of (1) its knowledge base, availability and depth of resources, (2) reputation for client service and demonstrated responsiveness throughout the search process and (3) its fit with FINRA's investment philosophy and culture.[86] The Investment Committee concurred and recommended hiring Slocum.[87] On January 22, 2004, the Finance Committee unanimously approved the selection of Slocum and agreed that the transition from Concord to Slocum would be left to management.[88] The decision did not require the approval of the Board.[89]

FINRA relied on Slocum's assistance in selecting managers and implementing the Investment Policy until an internal Investment Office was created in late 2006. Slocum would make recommendations to Mr. Diganci. If he approved the recommendations, he would present the proposed investment to the Investment Committee. Slocum made recommendations only; it did not have discretion to make decisions on behalf of FINRA.

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84 01/21/04 Invest. Cmte. Minutes at 2.

85 01/21/04 Invest. Cmte. Minutes at 2.

86 01/21/04 Invest. Cmte. Minutes at 2.

87 01/21/04 Invest. Cmte. Minutes at 2.

88 01/22/04 Fin. Cmte. Minutes at 1-2.

89 01/22/04 Board Minutes at 8.

4. 2005 Asset Allocation Review and Revision

a. Steps Taken by the Investment Committee

After FINRA's portfolio had been restructured in accordance with the new asset allocation policy and Slocum had been retained, the Investment Committee requested that Slocum prepare an asset allocation study to revisit the return expectations of the portfolio.[90] As part of the study, management requested that Slocum also present alternative combinations of portfolio asset allocation for the Investment Committee to consider in evaluating the appropriate risk and return objectives of the portfolio.[91]

Slocum's asset allocation study was presented at the Investment Committee's January 26, 2005 meeting.[92] The study presented two alternative portfolios for the Investment Committee's consideration, both of which proposed investments in real assets.[93] The alternative portfolios also increased the allocation to absolute return strategies ("ARS") from the 6% allocation of the current portfolio and reduced allocations to equities and fixed income.[94] One alternative portfolio proposed an allocation to ARS of 15%, while the other proposed 20%.[95]

The Investment Committee questioned the return assumptions that Slocum had used for private equity in light of a widespread belief that private equity returns in the future would not match those achieved in the past.[96] The Investment Committee asked Slocum what impact the

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90 01/12/05 Asset Allocation Strategy Review Discussion Item at 1.

91 01/12/05 Asset Allocation Strategy Review Discussion Item at 1.

92 01/26/05 Invest. Cmte. Minutes at 1.

93 01/12/05 Asset Allocation Strategy Review Discussion Item at 1.

94 01/12/05 Asset Allocation Strategy Review Discussion Item at 1.

95 01/12/05 Asset Allocation Strategy Review Discussion Item at 1.

96 01/26/05 Invest. Cmte. Minutes at 1.

reduction of those assumptions would have on the proposed asset allocations.[97] Slocum responded that changing the private equity return assumptions would not significantly alter the recommendations because the recommendations were driven primarily by correlations, which were not affected by the return assumptions.[98] Slocum agreed to include a sensitivity analysis addressing the Investment Committee's concerns in the final report to be presented at the Investment Committee's April 2005 meeting.[99]

After receiving Slocum's initial report, the Investment Committee then discussed the two proposed alternative portfolios.[100] The Investment Committee agreed with the "directional movement toward a greater percentage" of ARS.[101] The majority of the Investment Committee expressed a preference for the proposed portfolio with a "higher allocation to ARS (20% vs. 15%), a greater reduction in fixed income" and "higher expected returns for the same level of risk."[102]

At the April 20 meeting, the Investment Committee reviewed the revised asset allocation report prepared by Slocum that included the sensitivity analysis the Committee had requested at the January meeting.[103] The sensitivity analysis indicated that lowering the private equity return assumptions would not change the recommended allocations.[104] The Investment Committee members expressed satisfaction with the analysis and stated that the additional information was

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97 01/26/05 Invest. Cmte. Minutes at 1.

98 01/26/05 Invest. Cmte. Minutes at 1.

99 01/26/05 Invest. Cmte. Minutes at 1.

100 01/26/05 Invest. Cmte. Minutes at 1.

101 01/26/05 Invest. Cmte. Minutes at 1.

102 01/26/05 Invest. Cmte. Minutes at 1.

103 04/20/05 Invest. Cmte. Minutes at 1.

104 04/20/05 Invest. Cmte. Minutes at 2.

responsive to their concerns.[105] The Investment Committee again discussed the two alternative asset allocation policies recommended in the study and discussed the merits of adding real asset strategies to the portfolio.[106]

At the July 20, 2005 Investment Committee meeting, the proposed changes to the asset allocation policy were discussed again for the benefit of William Heyman, who had newly joined the Committee.[107] Mr. Heyman "questioned the timing of the increases in allocation to ARS, expressing concerns with overworked strategies, reduced talent levels, and misalignment of incentives."[108] The Investment Committee discussed the "importance of taking a longer-term view, of being extremely selective in looking for people and strategies that add value, and being comfortable with the downside risk of the overall portfolio."[109]

b. Information Considered by the Investment Committee

Slocum's revised asset allocation report provided the Investment Committee with, among other things, (1) the near-term and long-term return assumptions for various asset classes, (2) Slocum's long-term risk and return assumptions compared with those of Harvard, (3) historical asset correlations, (4) commentary on the current outlook for various asset classes and the expected annual return for such classes, (5) Sharpe Ratio data and downside risk statistics for FINRA's current policy and (6) the two proposed alternative portfolios.[110] An appendix to the report also provided analysis and commentary on real asset strategies.[111]

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105 04/20/05 Invest. Cmte. Minutes at 2.

106 04/20/05 Invest. Cmte. Minutes at 2.

107 07/20/05 Invest. Cmte. Minutes at 1.

108 07/20/05 Invest. Cmte. Minutes at 1.

109 07/20/05 Invest. Cmte. Minutes at 1.

110 05/05 Asset Allocation Strategy Review.

111 05/05 Asset Allocation Strategy Review.

c. The Investment Committee's Recommendations

After discussing the information provided by Slocum and management, the Investment Committee agreed to reduce the allocations to equities and fixed income and increase the allocations to alternatives by adding a 7.5% allocation to real assets and increasing the allocation for absolute return strategies and hedge funds from 6% to 20%. The Investment Committee endorsed the following asset allocations:[112]

2005 INVESTMENT POLICY STATEMENT ASSET ALLOCATIONS		
Asset Class	Allowable Range	Target Allocation
Domestic Equities	15%-25%	20.5%
Int'l Equities/ Emerging Markets	12%-18%	14.5%
Private Equities	8%-12%	10.0%
Total Equities	35%-50%	45.0%
Domestic/Int'l Bonds	10%-20%	16.0%
Cash	0%-5%	0.0%
Total Fixed Income	10%-25%	16.0%
Absolute Return/Hedge Funds	15%-25%	20.0%
Emerging Market Debt/Equities	2%-6%	4.0%
Real Estate	5%-10%	7.5%
Real Assets	5%-10%	7.5%
Total Alternative Invest.	35%-50%	39.0%
Total		100%

d. The Investment Committee's Rationale

The Investment Committee's rationale for the changes to asset allocation was to reduce volatility while maintaining the expected annual return.[113] The basis for this rationale was Slocum's analysis showing that the recommended changes would "increase the expected return of the portfolio from 8.4% to 8.9% under near-term assumptions, and reduce the risk (standard

[112] 2005 IPS at Apdx. A; 04/20/05 Invest. Cmte. Minutes at 2.

[113] 04/20/05 Invest. Cmte. Minutes at 3; 01/12/05 Asset Allocation Strategy Review Discussion Item at 1.

deviation) from 3.8% to 3.1%."[114] Slocum's analysis further indicated that, under long-term assumptions, the expected return increased from 10.4% to 10.7% with expected risk dropping from 3.5% to 3.1%.[115]

The Investment Committee also relied on Slocum's analysis showing that, while the current allocation policy had a greater than 99% probability that losses over a three year period would not exceed 3.9% ($41 million),[116] and a greater than 99% probability that losses over one year would not exceed 15.2% ($161 million), under the revised allocation policy those worst-case losses were reduced to 1.9% ($20 million) and 11.8% ($125 million), respectively.[117]

e. The Board Approves the Recommended Revised Asset Allocations

Slocum's revised asset allocation study was reviewed with the Finance Committee at its April 21 meeting.[118] At its July 21 meeting, the Finance Committee discussed the Investment Committee's analysis and recommendations and approved the revised asset allocation policy.[119] The Finance Committee presented the revised asset allocation policy to the Board that same day and explained that the revised policy would "broaden the diversification of funds, increase [FINRA's] protection against inflation by adjusting the allocation of assets, allow for higher returns on a risk-adjusted basis, and provide greater flexibility in the determination of annual distribution."[120]

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114 04/20/05 Invest. Cmte. Minutes at 3.

115 04/20/05 Invest. Cmte. Minutes at 3.

116 As of March 31, 2005, the value of FINRA's portfolio was approximately $1.06 billion.

117 04/05 Asset Allocation Strategy Review at 15.

118 04/21/05 Fin. Cmte. Minutes at 2.

119 07/21/05 Fin. Cmte. Minutes at 2.

120 07/21/05 Board Minutes at 5.

Based upon the recommendations of the Finance Committee and the Investment Committee, and its own discussions, the Board unanimously approved the revised asset allocation policy.[121]

5. The 2006 Reconsideration of the Endowment Approach

a. The Decision to Hold a Joint Meeting

In 2005 and 2006, FINRA was in the process of receiving another $900 million of proceeds from its sale of NASDAQ. FINRA in fact received $444 million in 2005 and $448 million in 2006.[122] In 2006, FINRA's expenses were increasing at a faster rate than revenue, and management projected that negative cash flows were on FINRA's horizon. Also at this time, Mr. Heyman was encouraging the Finance and Investment Committees to reconsider FINRA's investment approach. In light of these issues, the Investment Committee and Finance Committee scheduled a joint meeting for April 18, 2006 to discuss whether any changes to asset allocation were appropriate and how to address the projected negative cash flow.[123]

b. Joint Meeting Process

As part of the joint meeting, Messrs. Heyman and Malpass were asked to brief the Committees on the benefits and risks of portfolio allocations tilted toward fixed income and alternative investments.[124] Mr. Heyman argued in favor of investing the portfolio primarily in fixed-income securities. Mr. Malpass argued for maintaining the status quo. This process was in accordance with one of the purposes for which Messrs. Heyman and Malpass had been chosen to

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121 07/21/05 Board Minutes at 5.

122 FINRA Investments Since Inception Analysis, Ex. A.

123 04/12/06 Memo from R. Glauber to Fin. and Invest. Cmtes.

124 04/12/06 Memo from R. Glauber to Fin. and Invest. Cmtes.

serve on the Investment Committee: to provide different views on asset allocation and to encourage informative debate and thoughtful deliberation.

At the meeting, Mr. Heyman expressed his concern that FINRA's members would not praise FINRA for investment gains but would be critical of losses. He stated his opinion that returns for alternative investments were inflated and that risks were higher, and benefits lower, than most people were anticipating. He argued that volatility and the potential for large losses would be reduced if FINRA held high-quality bonds.[125] He proposed that the Committees consider "defeasing" all or a portion of the desired spending amount with bonds, after which FINRA could invest the remainder of the portfolio in illiquid assets with higher expected returns and greater volatility.[126]

Mr. Malpass responded that fixed-income investments had risks of their own. He "reviewed the history of alternative investments" pointing out that "these investments are here to stay, as they are extremely important in producing more consistent returns with greater risk control than conventional investments."[127] He expressed his opinion that FINRA had been "on the right path" by "following best practices for endowments" and that there was "no need to change."[128]

Some of those present at the April 18 meeting described the discussions between Mr. Heyman and Malpass as "healthy" and "rigorous," assisting the Committees in focusing on the risks associated with the manner in which assets were to be allocated.

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125 04/18/06 Joint Mtg. Minutes at 1.

126 04/18/06 Joint Mtg. Minutes at 1.

127 04/18/06 Joint Mtg. Minutes at 1.

128 04/18/06 Joint Mtg. Minutes at 1.

Other members of the Committees also expressed their views at the April 18 meeting. Supporters of the status quo noted that, historically, the endowment-style model had been a better model. They stated that members would best be served by a diversified portfolio designed to obtain the highest returns consistent with FINRA's tolerance for risk.

The Committees discussed the issues raised by Messrs. Heyman and Malpass "at length, including the need to be comfortable explaining portfolio losses to [FINRA's] constituencies, i.e., its members, the SEC and Congress, as well as the need to be cognizant of the liquidity of the portfolio in order to meet annual cash flow needs."[129] The Committees focused on determining what type of investment strategy was most likely to meet the objective of serving the short-term needs of members and the long-term needs of FINRA.

With respect to the cash flow concerns, the Committees "reviewed future cash flow and portfolio projections with the objective to reach consensus on the tolerance for loss in the investment portfolio and the extent to which the portfolio should be relied upon to bridge negative cash flow projections."[130] The Committees discussed the portfolio's role in supplementing future cash flow and the maximum investment losses that FINRA could withstand in light of the cash flow needs.

c. Information Considered by the Committees

The Finance and Investment Committees' discussions and decisions at the April 18 meeting were guided by the Committees' pre-existing knowledge of the work performed by the Ad Hoc Investment Committee in 2003 and the asset allocation study conducted in 2005. This knowledge included the information considered and rationales for those earlier decisions. All

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129 04/18/06 Joint Mtg. Minutes at 1.

130 04/18/06 Joint Mtg. Minutes at 1.

but two of the eleven members of the Finance and Investment Committees at the April 18 meeting had been members of the Ad Hoc Investment Committee, Investment Committee and/or Finance Committee when those previous decisions were made.[131]

The Finance and Investment Committees also received additional information specifically for purposes of the April 18 meeting. At the Investment Committee's earlier meeting in February, FINRA's investment advisor, Slocum, led a discussion that was meant to get the Investment Committee "thinking about the goals and objectives of the quasi-endowment, as well as [FINRA's] risk tolerance, in advance" of the asset allocation policy review scheduled for April.[132]

Management, with assistance from Slocum, also provided to the Finance and Investment Committees information and analysis relating to the historical performance of FINRA's portfolio, annual spending alternatives and return requirements, return assumptions, correlations and expected returns and losses for various asset allocation strategies. For the discussion about the role the portfolio would have on FINRA's cash flow, management provided the Finance and Investment Committees with information and analysis on cash flows, expenses, revenues and member rebates.[133]

d. Joint Meeting Decision

After reviewing the information provided by management and debating asset allocation strategy, the Committees reaffirmed that FINRA's investments would be invested "on a long

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131 Only Messrs. Heyman and Simmers were not members of the Investment Committee or Finance Committee when the earlier work was performed.

132 02/01/06 Invest. Cmte. Minutes at 3.

133 04/18/06 Joint Mtg. Minutes at 1.

term basis following endowment best practices."[134] With respect to the portfolio's role in the budget, the Committees reaffirmed that "one of the key objectives of the portfolio" was "to support the annual operating budget of [FINRA] for the benefit of its members with no intention to dissipate the endowment or to grow the endowment."[135] The Committees determined that the "endowment subsidy to support the annual operating budget should be no more than 10% to 12% of annual expenses," which at the time equated to $60 to $75 million.[136]

Having discussed how much FINRA could afford to lose from the portfolio in light of the portfolio's role in supporting the budget, the Committees also determined that the "tolerance for portfolio loss should be limited to no more than $150 million over a two year period" and that the "two year draw down between cumulative portfolio losses and annual budget subsidies should not exceed $300 million[.]"[137]

This $150 million risk tolerance was not a mandate or guarantee that the portfolio should lose no more than $150 million.[138] It was intended by the Committees to be used as a "guiding light" for investment decisions.[139] The Committees agreed that, if the risk tolerance were

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[134] 04/18/06 Joint Mtg. Minutes at 2.

[135] 04/18/06 Joint Mtg. Minutes at 2.

[136] 04/18/06 Joint Mtg. Minutes at 1.

[137] 04/18/06 Joint Mtg. Minutes at 1.

[138] Some questions were raised and discussed during the meeting about whether the $150 million risk tolerance was realistic in light of the potential losses that the investment strategy was capable of producing and the speed with which FINRA would be able to exit the market once $150 million of losses had occurred. Members of the Investment Committee stated during their interviews that the manner in which the Investment Committee determined that the portfolio was highly unlikely to produce a loss exceeding $150 million was broadly accepted at the time.

[139] Members of management and the Investment Committee explained during their interviews that, to determine whether an investment portfolio is within the risk

exceeded, FINRA's investment strategy should be reevaluated. There was no expectation however that exceeding the stated risk tolerance would automatically trigger a shift to a more conservative investment policy.

e. Joint Meeting Rationale

The Committees reaffirmed the decision to invest in the manner of an endowment for generally the same reasons the strategy was originally adopted: the Committees concluded that this policy would best serve current members while preserving the purchasing power of the corpus. They concluded that it would achieve the highest return on the portfolio within the stated risk tolerance.

The Committees set the stated risk tolerance at $150 million based on a combination of (1) projections and recommendations provided by management, (2) conversations with management about how much loss FINRA could withstand without materially changing its operations and (3) modeling of risks and returns. Management's recommendation of $150 million was based in part on analysis from Slocum indicating that, if the future resembled the past, there was only a 2.5% chance that the portfolio would lose $150 million or more in any one year.[140]

f. The Board Approves the Work of the Finance and Investment Committees

The Investment Committee met on April 19, 2006 to discuss the conclusions reached at the April 18 Joint Committee meeting and to determine whether there was a "need to make any changes to the current asset allocation policy given the main conclusions reached at the joint

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tolerance, one looks at the volatility of and correlation between the asset classes, researches the managers and analyzes how the investments fit together.

140 March 2006 Asset Allocation Strategy Review at 8.

committee meeting."[141] The Investment Committee reviewed the "current asset allocation's expected 2-year loss at a 95% confidence level and its expected return net of investment management fees" and concluded that there was "no need to adjust the current asset allocation policy ranges[.]"[142] The Finance Committee approved this decision at its July 20, 2006 meeting and also recommended to the Board an Investment Policy Statement that did not contain any changes to the asset allocation policy.[143]

For its July 20 meeting, the Board received in its kit a summary of the process and conclusions of the April 18 joint Finance and Investment Committees' meeting.[144] At the meeting, Sir Brian Corby provided a report of the April 18 joint meeting and described the asset allocation strategy that the Finance Committee was recommending remain in place.[145] Mr. Heyman described to the Board the concerns that he had expressed at the April 18 meeting. Others spoke about their reasons for supporting the endowment-style strategy. After further discussion, the Board approved the proposed Investment Policy Statement, which contained no changes to the asset allocation policy.[146]

6. The September 2008 Reconsideration of the Endowment Approach

a. The Investment Committee's Discussions

The asset allocations remained largely the same between 2006 and the 2008 market decline. As the portfolio began to decrease in value during the first half of 2008, at least one

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141 04/19/06 Invest. Cmte Minutes at 2.

142 04/19/06 Invest. Cmte Minutes at 2.

143 07/20/06 Fin. Cmte. Minutes at 2.

144 07/04/06 Asset Allocation Policy Action Item at 1.

145 07/20/06 Board Minutes at 5.

146 07/20/06 Board Minutes at 5.

member of the Investment Committee suggested reconsidering FINRA's investment strategy in light of the market conditions. Most of the members of the Investment Committee were not as anxious to revise the strategy. They explained, during their interviews, that an endowment-style investment strategy is a long-term approach that recognizes that there will be negative years and does not require constant revisiting.

FINRA's losses increased to 9.36% year-to-date by September 2008.[147] FINRA's management became concerned about how the losses would affect the members' perception of FINRA as a regulator. In light of the losses and management's concerns, Chairman Corby posed a series of questions to the Investment Committee at its September 15 meeting designed to begin another broad-ranging discussion about FINRA's investment strategy.[148] More specifically, the Investment Committee discussed "whether the portfolio objectives needed to be revisited and whether the 'endowment' model [was] the right model to achieve [those] objectives."[149]

b. Information Considered by the Investment Committee

i. Pre-Existing Knowledge

The Investment Committee's decision-making process at the September 15 meeting was guided in part by the Investment Committee's pre-existing knowledge of the work performed by the Ad Hoc Investment Committee in 2003, the asset allocation study conducted in 2005 and the work performed by the Finance and Investment Committees during their joint meeting in 2006.

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147 The paper loss thus appears to have exceeded the $150 million tolerance for losses over a two-year period. A rough calculation indicates that, when the value of FINRA's portfolio at the beginning of 2008 ($1.973 billion) is multiplied by the year-to-date percentage loss as of August 31, 2008 (9.36%), 2008 losses through August 31 were roughly $185 million dollars.

148 09/15/08 Invest. Cmte. Minutes at 2.

149 09/15/08 Invest. Cmte. Minutes at 2.

This knowledge included the information considered and rationales for those decisions. In fact, all the members of the Investment Committee who participated in the September 15 meeting, with the exception of Kurt Stocker, had also participated in the deliberation about investment strategy and asset allocation at the 2006 joint meeting and were therefore aware of the benefits and potential consequences of continuing the current asset allocation policy.

ii. Management Input

In determining whether to continue or alter the asset allocation policy, the Investment Committee also received and relied upon information provided by management. Management kept the Investment Committee apprised of the portfolio's performance throughout 2008. At the earlier April 16, 2008 Investment Committee meeting, for example, Boris Wessely informed the Committee that portfolio performance was down 3.5% for the year, which was in line with the index, and also explained that the portfolio retained significant liquidity.[150]

At the July 17, 2008 Board meeting, at which all members of the Investment Committee but Messrs. Malpass and Romano had been present, Mr. Diganci explained that the portfolio had declined 5-6% total, but "noted that the portfolio was well diversified with 70% of the portfolio being highly liquid."[151]

At the September 15 meeting, Mr. Wessely informed the Committee that, as of July 31, performance was down 8.1% year to date, lagging the index by 2.2%.[152] He explained that the "major detractor to performance was Real Assets, where relative performance in energy, commodities and REITs were no match for the absolute return benchmark of CPI + 5%[.]"[153]

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150 04/16/08 Invest. Cmte. Minutes at 1.

151 07/17/08 Board Minutes at 3.

152 09/15/08 Invest. Cmte. Minutes at 1.

153 09/15/08 Invest. Cmte. Minutes at 1.

In addition to receiving regular reports throughout 2008 about portfolio performance, the Investment Committee also received at the September 15 meeting a presentation by Mr. Wessely reviewing the investment portfolio within the framework of the current market.[154] This presentation included, among other things, (1) the status of the portfolio, (2) a list of investments made during 2008, (3) geographic and sector exposures and (4) investments under consideration.[155] Mr. Wessely highlighted the portfolio's liquidity and the advantage the liquidity provided in the current market.[156] He also discussed the opportunities for "diligent and patient investors who see a clear path for getting paid for risk."[157] Mr. Wessely added that the Investment Office was focused on implementing FINRA's investment strategy with a long-term focus and was taking steps to avoid any potential permanent impairment of assets.[158]

c. The Investment Committee's Decision

After Mr. Wessely's presentation, the Investment Committee discussed the current market conditions, the decline in the portfolio's value and what actions the Investment Committee should take in response. Some members expressed their views that the endowment-style strategy was a long-term strategy and that downturns were to be expected. Some were worried that the markets would get worse. Others expressed concern about the losses, but took the view that additional discussion was necessary before any changes were made. There "was

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[154] 09/15/08 Invest. Cmte. Minutes at 2.

[155] 09/15/08 Current Market Presentation.

[156] 09/15/08 Invest. Cmte. Minutes at 2.

[157] 09/15/08 Invest. Cmte. Minutes at 2.

[158] 09/15/08 Invest. Cmte. Minutes at 2.

general agreement that the Committee should not make changes to the asset allocation policy at [that] juncture," but that it should continue discussing the issue at the next meeting.[159]

At the September 16, 2008 meeting of the full Board, Sir Brian Corby reported that the Investment Committee had reviewed the portfolio reports, private equity and real assets and the current market environment. He stated that the Committee would continue to evaluate portfolio performance and "begin a series of discussions at its next meeting[.]"[160]

d. The Investment Committee's Rationale

The Investment Committee decided at the September 15 meeting not to alter the investment strategy immediately because it was a long-term strategy and because the Investment Committee understood the difficulty of attempting to time the market. There was generally a consensus that more information was necessary before any major changes were made.

7. September/October Market Decline

The bulk of FINRA's investment losses occurred in the few weeks following the September 15 Investment Committee meeting. By September 31, year-to-date losses had increased to 17.58%. By October 31, those losses had increased to 28.23%.[161]

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159 09/15/08 Invest. Cmte. Minutes at 2.

160 09/16/08 Board Meeting Minutes at 6.

161 In November 2008, the Investment Committee retained the services of an investment consultant, Ennis Knupp & Associates, to review its investment strategy and the Investment Office. EnnisKnupp conducted a thorough review and presented its findings to the Investment Committee in February 2009. The report suggested that, in light of the fact that FINRA had exceeded its stated $150 million risk tolerance, FINRA should seek to reduce the risk and volatility of its portfolio. After considering the issues raised by EnnisKnupp, the Investment Committee recommended, and the Board ultimately approved, a portfolio consisting of 50% fixed income and 50% diversified assets, managed externally by Wellington Management Company and HighVista Strategies, respectively.

C. Conclusion

The Committee concludes that FINRA has no genuine basis to claim that the members of management, the Investment Committee, the Finance Committee or Board acted in bad faith in recommending, adopting and thereafter continuing the endowment-style asset allocations that resulted in the 2008 losses.[162] FINRA cannot genuinely claim that such members intentionally

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[162] The Committee has also considered whether FINRA has a viable claim for fraud or negligent misrepresentation against any member of the Board, Finance Committee, Investment Committee, management or FINRA's investment advisors. The Committee was advised by counsel that, to assert a claim for fraud, FINRA would need to plead specific facts showing that (1) the member made a false statement, (2) the member knew or believed that the statement was false, or made the statement with reckless indifference to the truth, (3) the member intended to induce FINRA to act or refrain from acting, (4) FINRA's acted or refrained from acting in justifiable reliance upon the statement and (5) FINRA's action or inaction harmed FINRA. *See Lord v. Souder*, 748 A.2d 393, 402 (Del. 2000). To assert a viable claim of negligent misrepresentation, FINRA would need to plead specific facts showing that (1) the member had a duty to provide accurate information, (2) the member supplied false information, (3) the member failed to exercise reasonable care in obtaining or communicating the information, (4) FINRA acted or refrained from acting in justifiable reliance upon the false information and (5) FINRA's action or inaction harmed FINRA. *Grunstein v. Silva*, 2009 Del. Ch. LEXIS 206, at *54 (Del. Ch. Dec. 8, 2009).

The Committee has found no evidence that would plausibly support an argument that, with respect to FINRA's investments, the members of the Board, Finance Committee, Investment Committee, management or FINRA's investment advisors made a false statement, supplied false information to FINRA or failed to exercise reasonable care in obtaining or communicating information. The Committee therefore has concluded that, with respect to the investment losses, FINRA does not have a viable claim for fraud or negligent misrepresentation.

The Committee has also considered whether FINRA might have a viable claim for aiding and abetting a breach of fiduciary duty against any member of the Board, Finance Committee, Investment Committee, management or FINRA's investment advisors. The Committee was advised by counsel that a viable claim for aiding and abetting a breach of fiduciary duty arises only where a breach of fiduciary duty has occurred. *Malpiede v. Townson*, 780 A.2d 1075, 1096 (Del. 2001). As the Committee has determined that, with respect to investment decisions, no breach of fiduciary duty occurred, it has concluded that FINRA does not have a viable claim for aiding and abetting a breach of fiduciary.

failed to "act in the face of a known duty to act" or demonstrated a "conscious disregard" for their duties.

The facts rather show that the members took seriously their duties to invest the available funds in the best interests of FINRA's members. The Board, the Finance Committee and/or the Investment Committee repeatedly and diligently considered the asset allocations. They initially set the allocations in 2003, adjusted them in 2005, reconsidered them thoroughly in 2006 and reconsidered them again in 2008, each time with the benefit of their prior work. In doing so, they obtained input from some of the most experienced investment professionals available, including existing or former senior professionals from Harvard Management Company, the Notre Dame endowment, The Vanguard Group, the California Public Employees' Retirement System and The Travelers Companies, Inc. They also obtained input from management concerning the historical performance of FINRA's investments and FINRA's actual and projected financial needs. They also obtained input from FINRA's financial advisors concerning expected returns and historical volatility and correlations of assets in the existing and alternative potential investment portfolios. Particularly in 2006, but again in 2008, they considered strong cases for divergent investment strategies presented by the investment professionals. The picture that emerges from the facts uncovered by the investigation is one of serious individuals diligently and laboriously endeavoring to adopt the optimal strategy for FINRA and all its members and then to revisit it periodically to ensure that it was the best possible strategy.

The Committee also concludes that the reasons for which the members of the Board and relevant Committees adopted the endowment-style investment strategy were at least defensible under the circumstances. They therefore do not suggest a lack of good faith. The members reasoned that the endowment-style asset allocation would produce the greatest return for FINRA's members, while minimizing risk, over the long term. The Committee found that this

reasoning was consistent with the reasoning of many prominent investment professionals during the relevant time period.[163]

IV. PROPOSED CLAIMS FOR BREACH OF THE FIDUCIARY DUTY OF CARE

The Committee also examined whether the members of the Board, Finance Committee and/or Investment Committee breached their fiduciary duties of care in making the endowment decision and not changing it before the 2008 market decline.

A. Applicable Law

Delaware law does not permit courts "who may hold different views" to second-guess investment decisions of FINRA's Board and Committees.[164] Claims arising from a Board's "bad judgment," such as improvident investment decisions, are therefore "difficult to win[.]"[165]

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163 Although the strategy produced large losses for FINRA in 2008 that exceeded FINRA's risk tolerance, thereby prompting FINRA to revise the strategy, and unquestionably produced greater volatility than some alternatives, such as investing the available funds entirely in three-month United States Treasury bills, the strategy has not produced losses over the long term. Since the strategy was first implemented in 2004, the portfolio has generated a total annualized return of 2.8%, despite the 2008 losses. This exceeds the annualized returns for the S&P 500, at 2.1%, and three-month Treasury bills, at 2.6%.

164 *Canal Capital Corp. v. French*, 1992 Del. Ch. LEXIS 133, at *10 (Del. Ch. July 2, 1992).

165 *In re Countrywide Corp. S'holders Litig.*, 2009 Del. Ch. LEXIS 44, at *28 (Del. Ch. Mar. 31, 2009) ("Claims arising out of a board's bad judgment – for example, in improvident investments or risky underwriting protocols – are difficult to win because of the deference accorded the board's business judgment."). *See also Gagliardi v. Trifoods Int'l*, 683 A.2d 1049, 1052-53 (Del. Ch. 1996) ("Thus, to allege that a corporation has suffered a loss as a result of a lawful transaction, within the corporation's powers, authorized by a corporate fiduciary acting in a good faith pursuit of corporate purposes, does not state a claim for relief against that fiduciary no matter how foolish the investment may appear in retrospect."); *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 193 (Del. Ch. 2006) ("The business judgment rule exists precisely to ensure that directors and managers acting in good faith may pursue risky strategies that seem to promise great profit. If the mere fact that a strategy turned out poorly is in itself sufficient

To prevail on a claim for breach of the fiduciary duty of care, FINRA would have to prove that the decision-making process employed by the Board and its Committees in arriving at the decision was grossly negligent.[166] "Gross negligence" has been described by Delaware courts to mean "reckless indifference or actions that are without the bounds of reason."[167] Characteristics that might suggest that the Board and its Committees acted with gross negligence include making the decision with unnecessary speed, lack of preparation for meetings, lack of questioning or active involvement, making the decision without reference to relevant documents or a failure to consider reasonable alternatives.[168]

Counsel further advised the Committee that Delaware law "fully protects" the decision-making of boards and committees to the extent that they rely in good faith upon (1) the records of the corporation, (2) information, reports and opinions provided by the corporation's officers or

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to create an inference that the directors who approved it breached their fiduciary duties, the business judgment rule will have been denuded of much of its utility.").

166 *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Counsel further explained that in "instances where directors have not exercised business judgment, that is, in the event of director inaction," the "appropriate standard for determining liability is widely believed to be gross negligence[.]" *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 748 (Del. Ch. 2005) (*quoting In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996)). In addressing inaction by the Board and its Committees, the Committee was advised to examine the circumstances present during the relevant time period and determine whether, in light of those circumstances, inaction by the Board, Finance Committee or Investment Committee amounted to "reckless indifference" or was "without the bounds of reason." *McPadden v. Sidhu*, 964 A.2d 1262, 1274 (Del. Ch. 2008).

167 *Id.*

168 *See, e.g.*, *McMullin v. Beran*, 765 A.2d 910, 922 (Del. 2000); *Cede & Co. v. Technicolor*, 634 A.2d 345, 369 (Del. 1993); *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 66 (Del. 1989); *Mills Acquisition Co. v. Macmillan*, 559 A.2d 1261, 1281 (Del. 1988); *Van Gorkom*, 488 A.2d at 875; *Trenwick*, 906 A.2d at 193.

employees, (3) information, reports and opinions provided by a committee and/or (4) information, reports and opinions by advisors, so long as the advisor was selected with reasonable care and the subject relates to the advisor's area of expertise.[169]

B. Relevant Facts

The facts concerning the manner in which the Board, Finance Committee and Investment Committee made and revisited the endowment decision are set forth above.[170]

C. Conclusion

The Committee has concluded that FINRA does not have a credible claim against the members of the Board, Finance Committee or Investment Committee for breach of the fiduciary duty of care. The Committee has determined that there would be no genuine basis to claim that the members of the Board, Finance Committee or Investment Committee acted with gross negligence in making and revisiting the endowment decision.

To the contrary, the facts indicate that the members of the Board, Finance Committee and Investment Committee took great care in making the endowment decision. They took time in making it, considering and reconsidering it across multiple meetings in 2003, 2005, 2006 and

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[169] 8 *Del. C.* § 141(e). Counsel explained that the "full protection" of reliance on opinions/reports from officers, committees and other advisors is not available to the extent the Board or Finance Committee (1) did not in fact rely on the advisor, (2) relied on the advice in bad faith, (3) did not reasonably believe the advice was within the advisor's area of expertise, (4) failed to select the advisor with reasonable care, and the "faulty selection was attributable to" the Finance Committee/Board, (5) relied on advice from which was omitted information that was "so obvious and reasonably available that it was gross negligence for the Board [or Finance Committee] to fail to consider it, regardless of expert advice or lack thereof" or (6) made a decision so unconscionable as to constitute waste or fraud. *Selectica, Inc. v. Versata Enters.*, 2010 Del. Ch. LEXIS 39, at *62 (Del. Ch. Mar. 1, 2010).

[170] *See supra* at 25-53.

2008. They were prepared in making the decision, having obtained substantial relevant input from (1) the members of the Ad Hoc Investment Committee and Investment Committee (which included pre-eminent investment professionals), (2) members of management and (3) FINRA's well-respected financial advisor, Jeffrey Slocum & Associates. In making the decision, the members considered multiple alternatives and engaged in vigorous and candid deliberation.

The Committee has concluded that, even if FINRA's governors, which would not include Messrs. Malpass or Romano, had breached their fiduciary duties of care, FINRA would not have a viable claim against them for such breaches due to an exculpatory provision in FINRA's certificate of incorporation.[171]

V. PROPOSED CLAIMS FOR BREACH OF FIDUCIARY DUTY BASED UPON IMPLEMENTATION DECISIONS

The Committee also has investigated whether claims for breach of fiduciary duty should be asserted against the members of the Board, Finance Committee and/or Investment Committee based upon decisions that they made in implementing the endowment decision.

A. No Causation

As detailed previously,[172] the Committee has determined that the 2008 investment losses were attributable principally to the endowment decision.[173] Before this determination, the

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171 Article Fifth, section (l) of FINRA's certificate of incorporation states that a "Governor shall not be liable to the Corporation or its members for monetary damages for breach of fiduciary duty as a Governor, except to the extent such exemption from liability or limitation thereof is not permitted under" Delaware law. Counsel advised the Committee that Delaware law permits exculpation from monetary liability for breaches of the fiduciary duty of care. *See* 8 *Del. C.* § 102(b)(7). The Committee therefore has concluded that FINRA's governors are immune from monetary liability for breaches of their fiduciary duties of care. *See Emerald Partners v. Berlin*, 787 A.2d 85, 94 (Del. 2001).

172 *See supra* at 16-17.

Committee investigated whether any implementation decisions might also have contributed to the losses. In 2009, one of FINRA's investment advisors, EnnisKnupp, expressed concerns about the decision made in 2006 to create an internal Investment Office and rely less on external advisors in the selection of managers, the comparatively small size of the staff of the Investment Office, the sufficiency of the compensation paid to the staff, the shared responsibility between the Investment Committee and the Investment Office in selecting managers and the quality of communications between the chief investment officer and the Investment Committee. EnnisKnupp did not address whether the issues that it raised had contributed to the investment losses.

The Committee has concluded that the implementation decisions about which EnnisKnupp expressed concerns almost certainly did not contribute to the 2008 losses, but rather may have improved the performance of the portfolio. Analysis of FINRA's portfolio performance reports shows that the investments made by FINRA after the creation of the Investment Office modestly outperformed those made previously. Although the timing of the

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[173] The portfolio under-performed its benchmarks in the asset classes for the year ended 2008. The Committee has determined however that the momentary underperformance in 2008 does not warrant a conclusion that the endowment decision was poorly implemented; again, the portfolio performed at the median for endowments through late 2008 and into 2009. *See supra* at 17. A table, attached to this report as Exhibit B, sets forth, from Jan. 1, 2003 to Dec. 31, 2009, the month-to-month performance of the portfolio and its benchmarks. It shows that, during the years preceding 2008, it was not unusual for the portfolio to underperform the benchmarks for several months before subsequently overperforming the benchmarks. The data indicates that the portfolio's variance from the benchmarks at the end of 2008 may have been a short-term aberration resulting from the chaotic market. In their interviews, members of the Investment Committee discussed the problematic nature of short-term comparisons to benchmarks, particularly during a chaotic market, and stated that they did not believe the portfolio's deviation from the benchmarks at the end of 2008 was indicative of poor implementation.

investments or other factors may explain the difference in performance, the Committee has uncovered no information to suggest that the creation of the Investment Office and the related implementation decisions addressed by EnnisKnupp had a detrimental effect on the subsequent selection of managers and the resulting performance of the portfolio.

B. No Breach of Fiduciary Duty

Even if the implementation decisions had contributed to the losses, the Committee does not believe that FINRA could assert viable claims for breach of fiduciary duty against those who made the decisions for the reasons discussed below.

1. Claims for Breach of the Fiduciary Duty of Loyalty Based Upon Implementation Decisions

a. Applicable Law

This report summarizes above the advice of counsel concerning the law applicable to claims for breach of the fiduciary duty of loyalty.[174]

b. Relevant Facts

The Committee has investigated whether any member of the Board, Finance Committee or Investment Committee had a personal interest, not shared with FINRA's members generally, in the implementation decisions described above. All persons interviewed by the Committee concerning the investment losses were asked whether they knew of anything that might possibly suggest that any of these individuals had any personal interest in these implementation decisions just described or lacked independence from anyone who had such an interest. Those interviewed uniformly responded in the negative.

174 *See supra* at 19-20.

The Committee and/or its counsel also has reviewed the governor questionnaires in which the governors provided background about themselves that may be used to identify potential conflicts. The Committee also considered known business affiliations of the relevant persons. This process did not uncover any undisclosed interest in the implementation decisions.[175]

c. Conclusion

The Committee concludes that FINRA has no viable claim that any member of the Board, Finance Committee or Investment Committee breached his or her fiduciary duty of loyalty in making the implementation decisions.

2. Claims for Breach of the Fiduciary Duty of Good Faith Based Upon Implementation Decisions

a. Applicable Law

This report summarizes above the advice of counsel concerning the law applicable to claims for breach of the fiduciary duty of good faith.[176]

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175 This is not to say that individual members of the Board or relevant Committee did not have occasional potential conflicts concerning whether to select particular investment managers. Under such circumstances, the Board or Committee member disclosed the conflict and did not participate in the deliberations, even though the potential benefit likely was so small as to be immaterial. For example, Mr. Burton did not participate in the decision to invest in an exchange-traded gold fund created by the World Gold Council, of which Mr. Burton was chief executive officer. 12/01/05 Fin. Cmte. Minutes at 3; 11/30/05 Invest. Cmte. Minutes at 1-2. When the Investment Committee recommended investing in ING Clarion Real Estate Securities, John Simmers, the Chairman and chief executive officer of ING Advisors Network, recused himself. 09/21/06 Fin. Cmte. Minutes at 3. When the Investment Committee considered a proposed allocation to the Russia Partners II Fund, Mr. Malpass informed the Investment Committee that Notre Dame was invested in the fund and that he sat on the advisory board of Russia Partners. 01/26/05 Invest. Cmte. Minutes at 3. Although Mr. Malpass did not have any financial interest in Russia Partners, he recused himself from the decision to avoid any perceived conflict of interest.

176 *See supra* at 24-25.

b. Relevant Facts

i. Creation of Investment Office

At the February 2, 2006 Board meeting, Raymond "Chip" Mason suggested that, given the $2 billion size of FINRA's portfolio, FINRA should consider having internal staff manage the portfolio.[177] Chairman Glauber "agreed that this could be the right decision" and asked management to "consider the suggestion and report back to the Board."[178]

Management discussed this issue with the Investment Committee at the Investment Committee's April 19, 2006 meeting. The Investment Committee discussed whether FINRA would be able to assemble the right people to run an internal Investment Office.[179] The Investment Committee considered the issue and agreed that an Investment Office was "well justified due to asset size" (at the time in excess of $2 billion) and "in order to carry out attendant fiduciary responsibilities for the best interests of the members and organization."[180] The Investment Committee asked the staff to draft a blueprint for the proposed Investment Office.

Management began researching and analyzing investment offices of other organizations to understand how they functioned. Mr. Malpass, who ran Notre Dame's investment office, provided substantial input on the issue. FINRA's counsel reviewed FINRA's committee charters and advised management on governance issues related to the proposed Investment Office.

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177 02/02/06 Board Minutes at 7.

178 02/02/06 Board Minutes at 7.

179 The Committee was told by members of the Investment Committee that if an organization was going to have an endowment-style investment strategy in 2006, it would have needed an investment office because there were not any good external management options available at the time. The interviewees also stated that to invest with the best managers, a potential investor needs credibility and consistency in order to be perceived as sophisticated – goals that can be accomplished through a chief investment officer and internal investment office.

180 07/04/06 Approval of Asset Allocation Policy Action Item at 2; 04/19/06 Invest. Cmte. Minutes at 3.

Management, with the aid of the Investment Committee, created a blueprint for the Investment Office that initially consisted of a chief investment officer and three or four staff members. The blueprint provided for fewer initial staff members because management anticipated that the Investment Office would have the assistance of investment advisors and the expertise of the Investment Committee, which was expected to have a substantial role in the decision-making process.

Management presented the proposed Investment Office blueprint to the Finance Committee at the Finance Committee's July 20 meeting. In addition to presenting details about the proposed Investment Office, management's presentation provided information about the internal investment offices of other organizations with endowment-style investment strategies so that the Finance Committee could compare their structure to that of the proposed FINRA Investment Office. The Finance Committee considered the issue and recommended that the Board approve the creation of the Investment Office.[181] After receiving management's presentation and the Finance Committee's recommendation, the Board approved the proposed blueprint.[182]

ii. Hiring of a Chief Investment Officer

After the Investment Committee approved the creation of the Investment Office, management commenced a search for a chief investment officer.[183] Mr. Diganci was ultimately responsible for selecting the new chief investment officer. To assist with the search, he hired a search firm to identify potential candidates.[184] Once identified, candidates had a number of

181 07/20/06 Fin. Cmte. Minutes at 2.

182 07/20/06 Invest. Cmte. Minutes at 2; 07/20/06 Board Minutes at 5.

183 07/20/06 Board Minutes at 5.

184 07/19/06 Invest. Cmte. Minutes at 3.

interviews with members of management.[185] The list of candidates was eventually narrowed to three finalists.[186]

Each finalist met with members of the Investment Committee.[187] The general consensus among management and the Investment Committee was that Boris Wessely was the best candidate. Mr. Wessely had previous experience managing a diverse group of investments, including alternative investments.[188] Members of the Investment Committee stated, during interviews, that there was no reason to believe Mr. Wessely would not make a good chief investment officer; he was risk aware, thoughtful, well-qualified and highly recommended by his references. Mr. Wessely therefore was hired as the new chief investment officer of FINRA.

The goal with respect to the Investment Office was to start with a few staff members and analysts and gradually increase the Investment Office's size while decreasing FINRA's reliance on external advisors. The Investment Office was expected to continue using the advisors as a tool for locating potential investment managers. As the Investment Office became established, Slocum's role therefore changed to that of information provider. As of April 2007, Slocum no longer provided investment advice. After that time, Slocum was retained only to provide FINRA with access to a database listing the investment managers that Slocum was currently researching.

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185 07/19/06 Invest. Cmte. Minutes at 3.

186 07/19/06 Invest. Cmte. Minutes at 3.

187 07/19/06 Invest. Cmte. Minutes at 3.

188 Prior to joining FINRA, Mr. Wessely was treasurer of the Rockefeller Brothers Fund, where he was responsible for managing a diversified $850 million investment portfolio.

iii. Manager Selection

Prior to the creation of the Investment Office, the Investment Committee recommended the selection and termination of investment managers to the Finance Committee.[189] After the Investment Office was created however the Investment Committee was given responsibility for selecting and terminating investment managers in conjunction with the Investment Office.[190] The Investment Office had authority to select investment managers, but required approval from the Investment Committee if the proposed investment: (1) was illiquid (could not be easily liquidated in less than one year); (2) had liquidity of more than 30 days but less than a year, and would constitute 1% or more of the portfolio or (3) was liquid (could be liquidated in less than 30 days) and would constitute 3% or more of the portfolio.[191]

Each manager was selected following due diligence and discussion. The due diligence began with modeling and analysis to determine how the manager behaved under various circumstances and how it would fit into FINRA's portfolio. As part of this analysis, the Investment Office would consider how the manager would fit into FINRA's overall risk budget and the risk budget established for the individual asset classes.[192]

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[189] 2005 IPS at 4.

[190] 2007 IPS at 3.

[191] 2007 IPS at 4.

[192] The Investment Policy Statement set forth a total risk budget and risk parameters based on benchmarks. 2007 IPS at 2; 2008 IPS at 2. The risk budget set the allowable measure of deviation at 15%, or 115% of total benchmark risks. 2007 IPS at 2; 2008 IPS at 2. The 2007 and 2008 Investment Policy Statements set forth the following expected volatility for the asset classes:

Asset Class	Target Allocation	Benchmark	Expected Volatility
Equities	40%	MSCI ACWI	19%
Marketable Alternatives	20%	HFRI FOF	5%
Private Equities	10%	Wilshire 5000 X 120%	21%
Real Assets	15%	CPI+5%	14%
Fixed Income	15%	Lehman Aggregate	8.5%

After this initial due diligence, the Investment Office would discuss the potential manager with management and the Investment Committee. If a manager was likely to be recommended or selected, Mr. Wessely would formally meet with Mr. Diganci and Ms. Schapiro to discuss the proposed manager, after which the investment would be approved by the Investment Office or forwarded for the approval of the Investment Committee.

According to Mr. Wessely, as the market declined in 2008, the Investment Office took particular care to make sure that FINRA did not have investments that were illiquid or that would be permanently impaired so that FINRA could withstand the downturn and benefit from the market rebound.

Although questions were raised about the effectiveness of Mr. Wessely's interactions with the Investment Committee, there appears to have been little or no concern about his selection of managers, particularly after vetting by the Investment Committee. Members of the Investment Committee stated, during their interviews, that they had no issues with Mr. Wessely's manager selections and believed that they were reasonable.

c. Conclusion

The investigation revealed no facts to suggest the members of the Board, Finance Committee or Investment Committee failed to take their responsibilities seriously in making the implementation decisions or made them for any reason other than to benefit FINRA and its members. As described above, the decision to create the Investment Office and the blueprint for the Investment Office were made with careful deliberation and planning. Mr. Wessely was hired after an extensive candidate search and interview process. The individual selection of managers

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Total	100%	Custom Benchmark	10%

2007 IPS at Apdx. A; 2008 IPS at 6.

was made by following due diligence procedures. Implementation decisions appear to have been made only after giving careful consideration to the best interest of FINRA's members. The Committee concludes that, even assuming – contrary to the Committee's prior determination – that the implementation decisions contributed to the 2008 losses, FINRA cannot assert a viable claim that the members breached their fiduciary duties of good faith in making the implementation decisions.[193]

3. Claims for Breach of the Fiduciary Duty of Care Based Upon Implementation Decisions

The Committee has considered whether viable claims for breach of the fiduciary duty of care might be asserted against the members of the Board, Finance Committee and Investment Committee. This report previously addressed the gross negligence required to prove a claim for breach of the fiduciary duty of care.[194] The facts concerning the care taken by the relevant decision-makers are summarized above.[195] The Committee concludes that they do not indicate any gross negligence by the relevant decision-makers.[196]

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193 The Committee also has considered whether other implementation decisions not identified above, such as the timing of divestitures, might have contributed to the losses in a manner that might have given rise to viable claims for breach of fiduciary duty. As detailed above, the Committee found that the members of the Board and Committees were disinterested and independent in making implementation decisions. It also found that such members acted in good faith. The Committee uncovered no information suggesting that the members were acting in bad faith at any time in making implementation decisions. The Committee therefore concludes that the possibility of a viable claim based upon any implementation decision is remote.

194 *See supra* at 56-58.

195 *See supra* at 25-53.

196 Additionally, the Committee has determined that, due to the exculpatory provision in FINRA's certificate of incorporation, viable claims for breach of the fiduciary duty of care could not be asserted against the members of the Board, Finance Committee and Investment Committee, other than Messrs. Malpass and Romano.

VI. PROPOSED CLAIMS AGAINST OTHERS

A. Proposed Claims Against Scott Malpass and Richard Romano

1. Applicable Law

Messrs. Malpass and Romano, both of whom were members of the Investment Committee, were not governors of FINRA. Counsel advised the Committee that the law concerning the potential liability of committee members who are neither directors nor officers is not well-developed. Counsel advised that courts might treat Messrs. Malpass and Romano as having fiduciary duties and business judgment protections like those of governors. The Committee therefore considered whether Mr. Malpass or Mr. Romano was interested, lacked independence, acted in bad faith or was grossly negligent in his decision-making.[197]

Alternatively, counsel informed the Committee that courts may treat Messrs. Malpass and Romano as advisors, subject to liability for professional malpractice if they acted negligently, but not subject to fiduciary duties. The Committee therefore considered whether there was any basis for concluding that Mr. Malpass or Mr. Romano acted negligently. Counsel advised the Committee that, to determine whether FINRA has a viable negligence claim against Mr. Malpass or Mr. Romano, it should consider whether any advice they provided deviated from generally accepted standards.[198]

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[197] Counsel advised the Committee that the exculpatory provision in FINRA's certificate of incorporation applied only to governors, and that if the Committee were to find that Messrs. Malpass or Romano breached any applicable duty, they would not be entitled to exculpation. *See Gantler v. Stephens*, 965 A.2d 695, 709 n.37 (Del. 2009) (explaining that 102(b)(7) applies only to directors).

[198] *Gallo v. Buccini/Pollin Group*, 2008 Del. Super. LEXIS 106, at *10 (Del. Super. Ct. Mar. 28, 2008) (explaining that a professional's "conduct and competency is evaluated against others who possess similar skills, expertise, training and knowledge").

2. Breach of Fiduciary Duty

Assuming that Messrs. Malpass and Romano are treated as having fiduciary duties, this report discusses above, as part of its analysis of potential claims against members of the Investment Committee, potential breach of fiduciary duty claims against Messrs. Malpass and Romano.[199] The Committee does not believe, for reasons already described,[200] that FINRA has a genuine basis to assert that any member of the Investment Committee, including Messrs. Malpass and Romano, breached his or her fiduciary duties of loyalty, good faith or care.

3. Negligence

The Committee also investigated whether Messrs. Malpass or Romano acted negligently in providing investment advice to FINRA that deviated from standards applicable to investment professionals during the relevant time period. For the reasons stated previously, the Committee has concluded that the advice provided by Messrs. Malpass and Romano, which was reflected in the recommendations by the Investment Committee, was consistent with commonly-held views during the relevant time period concerning appropriate investment strategy.

B. Claims Against Management

The Committee investigated whether any claims could be brought against any member of management relating to the investment losses. The Committee was advised by counsel that members of management owed the same fiduciary duties to FINRA as did the members of the

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199 *See supra* at 19-68.

200 *See supra* at 19-68.

Board and its Committees.[201] The Committee was also advised that members of management are similarly protected from liability for their decision-making absent a breach of those duties.[202]

The Committee has reviewed analyses, reports and presentations prepared by management relating to the decision to invest in the manner of a college endowment and relating to implementation decisions. The Committee has also interviewed members of the Board, Finance Committee, Investment Committee, Ad Hoc Investment Committee and management and inquired about management's role in the decision-making process described above and whether any member of management had an interest or lacked independence from someone with an interest in the endowment decision or the implementation decisions.

The Committee has noted that the Board, and not management, made the decision to invest in the manner of a college endowment. The Committee has further determined, for the reasons described above, that the implementation decisions did not have any effect on the losses suffered in the latter months of 2008. The Committee has not learned any fact suggesting, with respect to the endowment decision and implementation decisions, that (1) any member of management was interested or lacked independence, (2) any member of management acted in bad faith or (3) the information supplied by management or the manager selections made by the Investment Office was the product of gross negligence. The Committee therefore has concluded that FINRA cannot assert a genuine claim against the members of management for breach of fiduciary duty.

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201 *Gantler*, 965 A.2d at 708-709 (stating that the duties owed to a corporation by directors and officers are identical).

202 *Id.* (stating that, like directors, officers are protected by the business judgment rule).

C. Claims Against Slocum

The Committee was advised by counsel that Slocum most likely did not owe fiduciary duties to FINRA.[203] The Committee was further advised that, to determine whether FINRA might have a negligence claim against Slocum, FINRA would need to establish facts showing that Slocum's advice materially deviated from generally accepted standards.[204]

To investigate whether Slocum acted negligently in providing investment advice to FINRA, the Committee and/or its counsel reviewed the analyses, presentations, reports and memoranda that Slocum prepared for FINRA. It interviewed members of the Investment Committee and management about Slocum's performance.[205] The Committee's investigation did not reveal any basis for concluding that the advice provided by Slocum unreasonably deviated from the general knowledge and experience of investment professionals at the time.

D. Claims Against Counsel

The Committee investigated whether FINRA might have any claims against its legal counsel relating to the 2008 investment losses. The investigation revealed that FINRA's counsel had very little, if any, involvement in the decision to invest as an endowment.[206] FINRA's tax

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203 Although the law on the issue is not well-developed, it appears that an investment advisor may owe fiduciary duties to a corporation only when given authority to make decisions on the corporation's behalf. *See, e.g., Forsythe v. ESC Fund Mgmt. Co. (U.S.)*, 2007 Del. Ch. LEXIS 140, at *34 (Del. Ch. Oct. 9, 2007). Slocum did not have authority to make decisions on FINRA's behalf.

204 *Gallo*, 2008 Del. Super. LEXIS 106, at *10 (explaining that a professional's "conduct and competency is evaluated against others who possess similar skills, expertise, training and knowledge").

205 The consensus among the members of the Investment Committee and management that were interviewed was that Slocum's analysis was appropriate and its advice was generally well founded.

206 Members of the Investment Committee and management stated, during their interviews, that they did not recall FINRA's counsel being involved in the investment process.

counsel, Davis Polk & Wardwell, advised FINRA on inurement issues that might arise if FINRA remitted the NASDAQ proceeds to its members. The Committee's investigation has uncovered no facts indicating that the advice provided by Davis Polk & Wardwell was not well founded.

FINRA's general counsel advised management on governance issues during the process of creating the Investment Office. The Committee has not found that the creation of the Investment Office had any impact on the 2008 investment losses. Additionally, the Committee's investigation has not produced any facts indicating that the general counsel's advice was incorrect or that he acted with self-interest, a lack of independence, in bad faith or with gross negligence. The Committee therefore has concluded that FINRA does not have a viable claim against its counsel relating to the 2008 investment losses.

PART TWO: EVALUATION OF CLAIMS CONCERNING COMPENSATION

This part of the report is divided into five sections. Section I provides background concerning the compensation that was investigated. Section II addresses claims for breach of the fiduciary duty of loyalty against the members of FINRA's Board and Compensation Committee who approved the compensation. Section III addresses claims against the same persons for breach of the fiduciary duty of good faith. Section IV addresses claims against the same persons for breach of the fiduciary duty of care. Section V addresses proposed claims against (1) FINRA's management, (2) Mercer, FINRA's management compensation consultant, and (3) legal counsel for FINRA.

I. BACKGROUND

A. Description of Compensation

Compensation paid to senior management at FINRA consisted of three types: base salary, incentive compensation and retirement benefits. During the relevant time period, most of the

retirement benefits took the form of a Supplemental Executive Retirement Program ("SERP").[207] FINRA did not offer its senior executives long-term incentives like stock options.[208]

Base salary was established based on individual performance and experience levels.[209] It was compared with and adjusted to competitive market pay levels on an annual basis.[210] To ensure that FINRA could attract the talented individuals necessary for regulation, the Compensation Committee determined that base salary levels were to be targeted at the 50th to 75th percentiles of comparable firms.[211]

Incentive compensation was "at risk" compensation designed to deliver total cash compensation (base salary + incentive compensation) at the 50th percentile of the market when an executive's performance was "at expectation."[212] Incentive compensation was paid after the year for which the incentive compensation was awarded had ended; in other words, 2007

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207 Senior management participated in both the general Employee Retirement Program ("ERP") and the SERP. Compensation Philosophy at Sec. V. The formula for the ERP benefit accrual was 1.25% of final average earnings (average of highest consecutive five years of base pay, subject to IRS limits of $245,000 in 2009) plus .5267% of final average earnings in excess of covered compensation (no more than $106,800 in 2009) for each year of service after 1/1/89. The maximum accrual therefore was $2,063 for each year of service ($106,800 X 1.25% + $138,200 X .5267%). A table setting forth the specific terms of the ERP in greater detail is attached to this report as Exhibit C.

208 11/20/07 Comp. Cmte. Minutes at 1; Compensation Philosophy at Sec. II. While there are means other than stock options for providing long-term incentives, it is difficult to measure long-term performance at FINRA because of the nature of its work, and long-term incentives are therefore impractical.

209 Compensation Philosophy at Sec. II.

210 Compensation Philosophy at Sec. II.

211 November 2009 Mercer Report at 3.

212 Compensation Philosophy at Sec. II. "When assessing pay levels, FINRA generally assume[d] that a position approximate[d] the market median when total direct compensation [fell] within ± 15% to ± 20% of the median composite data." *Id.* at Sec. III.

incentive compensation was paid to senior management in 2008, 2008 incentive compensation was paid in 2009, and so forth.

SERP benefits served as a "key attraction and retention tool for mid-career hires and serve[d] as a substitute for long term incentives."[213] The SERP was offered to all senior vice presidents and above and vice presidents whose base salaries exceeded the qualified plan compensation limit.[214] According to FINRA's Compensation Philosophy, the SERP was intended to provide benefits that, when valued, would fall within the 50th and 75th percentiles of SERP benefits at comparable organizations.[215]

FINRA's SERP was originally a defined benefit program (the "DB SERP") that provided annual retirement benefits to members of senior management of up to 60% of their average eligible compensation (base salary + 1/3 incentive compensation) during the five years before their retirement.[216] The DB SERP set vesting at age 55 with ten years of service.[217] The DB SERP benefits could also be received as an annuity or as a lump sum. A table setting forth the specific terms of the DB SERP in greater detail is attached to this report as Exhibit D.

In 2005, the Compensation Committee determined that the DB SERP was generous and its vesting policy was outdated. The Compensation Committee therefore closed the DB SERP to new participants, while allowing benefits to continue accruing in favor of existing participants.

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213 Compensation Philosophy at Sec. V.

214 Compensation Philosophy at Sec. V.

215 Compensation Philosophy at Sec. V.

216 *See* DB SERP Table, Ex. D.

217 *See* DB SERP Table, Ex. D. Benefits vested more quickly for some members of senior management. When FINRA decided to sell its interest in NASDAQ, it provided, as a retention tool, ten members of management with an enhanced SERP contract that provided for 50% vesting after five years of service, followed by 10% vesting per year thereafter.

For those excluded from the DB SERP, a "newly designed defined contribution program was introduced for all new entrants to reflect industry trends yet maintain FINRA's ability to attract and retain seasoned professionals."[218] For each senior executive in this defined contribution SERP (the "DC SERP"), FINRA contributed to a self-directed retirement fund a certain percentage of the senior executive's eligible compensation (base pay + 1/3 incentive compensation for senior vice presidents and above, base pay only for vice presidents).[219] Vesting occurred every three years, with all non-vested contributions vesting at age 62.[220] A table setting forth the specific terms of the DC SERP in greater detail is attached to this report as Exhibit E. Participants in the DB SERP were given the option of remaining in the DB SERP or transferring to the DC SERP.

B. Responsibility for Compensation Decisions

The Compensation Committee had authority to approve base salary and incentive compensation awards for all members of management whose total cash compensation exceeded $1 million, other than the chief executive officer.[221] The Compensation Committee was also tasked with (1) reviewing and recommending to the Board changes to FINRA's compensation and benefit plans and policies, (2) reviewing the goals and objectives of the chief executive

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218 Compensation Philosophy at Sec. V.

219 DC SERP Table, Ex. E. The percentage of income to be contributed for each individual depended on his or her level in management. For chief executive officer, FINRA contributed 20% of eligible compensation. For senior executive and executive vice presidents, the amount contributed was 16%. For senior vice presidents, FINRA's contribution was 12.5%, and for vice presidents it was 5%.

220 DC SERP Table, Ex. E.

221 2008 Comp. Cmte. Charter. Prior to February 2008, the Compensation Committee reviewed compensation of members of management whose based salary exceeded $350,000 or whose total cash compensation exceeded $600,000. 2003 Comp. Cmte. Charter.

officer and (3) evaluating the chief executive officer's performance and recommending to the Board changes to his or her base salary and incentive compensation. The Board retained the authority to (1) approve management compensation/benefit plans and policies and (2) approve the base salary and incentive compensation for the chief executive officer.[222]

II. PROPOSED CLAIMS FOR BREACH OF THE FIDUCIARY DUTY OF LOYALTY

A. Review of Applicable Law

As detailed previously,[223] the Committee was advised as follows concerning the law applicable to a claim for breach of the fiduciary duty of loyalty, putting aside issues of good faith, which are addressed separately below. To prevail on a claim that conduct by the Board or Compensation Committee constituted a breach of the duty of loyalty, FINRA must first establish that a majority of the members of the Board or Compensation Committee making the decision had a material personal interest in the decision or lacked independence from someone who had such an interest.[224] The lack of independence must arise from a familial, intimate personal or financial relationship with someone who was interested in the decision or inaction[225] and render the member "more willing to risk his or her reputation than risk the relationship with the interested" person.[226]

222 2008 Comp. Cmte. Charter.

223 *See supra* at 19-20.

224 If the above majority interest or lack of independence were established, FINRA would also need to establish that the decision or inaction was less than entirely fair to FINRA.

225 *Beam*, 845 A.2d at 1051-1052.

226 *Id.*

B. Relevant Facts

The Committee examined the interests and relationships of those members of the Board and Compensation Committee who made senior management compensation decisions for compensation paid between 2007 and 2009. Those members are listed in the table below, along with the decisions that they approved:

DATE OF APPROVAL	COMPENSATION APPROVED	MEMBERS APPROVING
January 11, 2006	Employment Contract of Mary Schapiro	Board: Glauber Duberstein Alsover Heyman Bakerink Isenberg Bowsher MacDonald Brueckner Mason Burton Rutherfurd Corby Smith DeMuro
February 1, 2007	Senior Management 2007 Base + 2006 Incentive Compensation (Total Cash Compensation)	Compensation Committee: Corby Heyman Brennan Smith
February 1, 2007	Schapiro 2006 Incentive Compensation (subject to final Board approval)	Same as above
February 1, 2007	2007 Base + 2006 Incentive Compensation (Total Cash Compensation) Of Top Five Senior Managers	Board: Schapiro Dedman Alsover Ferguson Bachmann Heyman Bowsher Kovak Brennan Rutherfurd Brueckner Seligman Burton Simmers Corby Smith
February 1, 2007	Schapiro 2006 Incentive Compensation	Same as above, excluding Schapiro
January 14, 2008	Senior Management 2008 Base + 2007 Incentive Compensation (Total Cash Compensation)	Compensation Committee: Corby Brown Heyman Pechter
January 14, 2008	Schapiro 2008 Base + 2007 Incentive Compensation (subject to final Board approval)	Same as above

February 7, 2008	Schapiro 2008 Base + 2007 Incentive Compensation	Board: Bowsher Jackson Brennan Ketchum Brown McCann Brueckner Pechter Burton Russo Corby Sargent Dolan Seligman Ferguson Simmers Goble Steel Goldschmid Stocker Heyman Williams
January 8, 2009	Senior Management 2009 Base + 2008 Incentive Compensation (Total Cash Compensation)	Compensation Committee: Heyman Pechter Brown
January 8, 2009	Schapiro 2008 Incentive Compensation (subject to final Board approval)	Same as above
January 16, 2009	Schapiro 2008 Incentive Compensation	Board: Bowsher Jackson Brennan Ketchum Brown Pechter Brueckner Sargent Buechner Seligman Burton Simmers Dolan Steel Ferguson Stocker Goldschmid Williams Heyman

Members of the Compensation Committee and management and representatives of Mercer that were interviewed were asked whether they were aware of any relationships, other than professional relationships, between any of the individuals listed above and any member of senior management. Each interviewee responded in the negative.[227] The Committee and/or

[227] Some members of the Board and Compensation Committee considered themselves friends of Mary Schapiro or other members of management. Counsel advised the Committee that "personal friendships, without more" are "insufficient to raise a reasonable doubt of a director's ability to exercise independent business judgment." *Cal. Pub. Emples. Ret. Sys. v. Coulter*, 2002 Del. Ch. LEXIS 144, at *29 (Del. Ch. Dec. 18, 2002) (observing that an allegation of a lifelong friendship

counsel also reviewed the annual questionnaires submitted by the individuals listed above. The answers to the questionnaires did not suggest any such relationship. Finally, the Committee reviewed the documentation concerning the compensation decisions, but found no evidence of any relationships that might give rise to a loyalty concern.

C. Conclusion

The Committee does not believe that any member of the Compensation Committee had a material interest in decisions relating to the compensation of the members of senior management or lacked independence from the members of senior management or anyone else who had such an interest. The Committee also does not believe that any member of the Board had a material interest in decisions relating to Mary Schapiro's compensation or lacked independence from Ms. Schapiro or anyone else who had such an interest. The Committee therefore concludes that FINRA does not have a basis to assert a claim against the members of the Board or Compensation Committee for breach of the fiduciary duty of loyalty in setting the senior management compensation paid during the years 2007, 2008 or 2009.

III. PROPOSED CLAIMS FOR BREACH OF THE FIDUCIARY DUTY OF GOOD FAITH

A. Review of Applicable Law

As previously discussed above,[228] the Committee was advised as follows concerning the law applicable to claims that the members of the Board and Compensation Committee breached their fiduciary duties of good faith in approving the compensation of senior management. To

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with an interested party alone was not sufficient to raise a reasonable doubt of a director's disinterest or independence). The Committee determined that such friendships were, alone, insufficient to support a finding that any of the members of the Board or Compensation Committee lacked independence with respect to decisions about senior management compensation.

228 *See supra* at 24.

prevail on a claim for breach of the duty of good faith, FINRA must establish that, even if without any conflicting interest or lack of independence, a majority of the members of the Board or Compensation Committee nonetheless intentionally failed "'to act in the face of a known duty to act, demonstrating a conscious disregard'" for their duties. Alternatively, FINRA might prevail on such a claim by showing that a majority acted "'with a purpose other than that of advancing the best interests'" of FINRA or "'with the intent to violate applicable'" law.[229]

B. Relevant Facts

Based upon the above advice, the Committee sought to determine whether, in approving the compensation paid to senior executives during the years 2007, 2008 and 2009, the members of the Board or Compensation Committee demonstrated a "conscious disregard for their duties" or otherwise violated their duties. To make this determination, the Committee thoroughly investigated what steps the members took to approve senior management compensation. The following is a description of the steps taken by the members of the Board and Compensation Committee to determine senior management compensation during the relevant years.

1. Compensation Committee Process

The Compensation Committee was guided in its management compensation decision-making by FINRA's Compensation Philosophy, which was first introduced in 2002, and reaffirmed by the Board in December of 2007, with the aid of FINRA's compensation consultant, Mercer Human Resource Consulting ("Mercer").[230] The Compensation Philosophy

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[229] *Stone*, 911 A.2d at 369 (*quoting In re Walt Disney*, 906 A.2d at 67). The Committee was further advised that a poor decision-making process, even if grossly negligent, alone would be insufficient to support a conclusion that the decision-maker acted in bad faith. *Lyondell*, 970 A.2d at 240.

[230] 11/20/07 Comp. Cmte. Minutes at 1; 12/04/07 Board Minutes at 4. The Compensation Philosophy was amended in December 2009 to, among other

states that FINRA's objectives with respect to management compensation are, among other things, to "[a]ttract, develop and retain high performing individuals" and "provide rewards commensurate with individual contributions and FINRA's overall performance."[231]

FINRA used the following procedure to meet these objectives. First, Mercer prepared benchmarking data for the actual compensation received the previous year by senior management. Second, the members of senior management were reviewed to determine how well they achieved their goals over the previous year. Third, the performance of FINRA as a whole and the state of the industry/economy was also reviewed. Fourth, the benchmark data provided by Mercer, the individual's goal achievements, FINRA's goal achievements and the state of the industry/economy were all taken into account by FINRA's chief executive officer, who recommended the appropriate level of pay for each member of senior management for the following year. Fifth, after compensation was recalibrated based on these factors, it was again benchmarked against comparable positions at comparable organizations. Finally, the Compensation Committee received this information and the recommendations of the chief executive officer and approved or revised the recommended compensation.

2. Base and Incentive Compensation

a. Comparisons of Base and Incentive Compensation

To aid the Compensation Committee and Board with the process described above, each year Mercer benchmarked total direct compensation (base salary + incentive compensation) against the total direct compensation (base salary + incentive compensation + long-term

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things, extend salary review cycles for senior management to 24 months. 12/08/09 Comp. Cmte. Minutes at 1-2; 12/09/09 Board Minutes at 7.

231 Compensation Philosophy at Sec. I.

incentive compensation) paid for similar positions at comparable organizations. As discussed below, Mercer's total direct pay comparisons did not include the value of the SERP benefits that the reviewed executives would receive.[232]

From 2007 to 2009, Mercer's conclusions were consistently that the "total pay positioning of FINRA's program remain[ed] appropriate."[233] For each year between 2007 and 2009, Mercer's benchmark analysis concluded that total direct compensation for almost all of the positions reviewed at FINRA fell between the 25th and 50th percentiles.[234] Total direct compensation for Mary Schapiro generally fell at or below the 25th percentile.[235]

Total direct compensation for senior management fell between the 25th and 50th percentiles primarily because FINRA, unlike many of the comparable organizations used for the comparisons, did not offer longer-term incentive compensation.[236] Instead, FINRA placed increased emphasis on base salary. Thus, from 2007 to 2009, Mercer's benchmark analysis indicated that senior executive base pay approximated or exceeded the 75th percentile levels.[237] When incentive compensation (but not the long-term incentive compensation paid by the comparable organizations) was added to the comparison, the compensation paid to FINRA's senior executives fell at or modestly above the market median.[238]

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232 02/01/07 Mercer Report at 17.

233 11/08 Mercer Report at 16.

234 02/01/07 Mercer Report at 17; 12/03/07 Mercer Report at 10-13; 11/08 Mercer Report at 13.

235 02/01/07 Mercer Report at 14; 12/03/07 Mercer Report at 10; 11/08 Mercer Report at 11.

236 02/01/07 Mercer Report at 15.

237 02/01/07 Mercer Report at 15; 12/03/07 Mercer Report at 13; 11/08 Mercer Report at 15.

238 02/01/07 Mercer Report at 15; 12/03/07 Mercer Report at 12; 11/08 Mercer Report at 14.

After the market decline in 2008, the Compensation Committee discussed the degree to which the decline (and its effect on comparable organizations) should be taken into account in determining senior management's compensation. The Compensation Committee concluded that senior management had not been rewarded as richly as their counterparts at comparable organizations during the preceding market increase, and should not therefore be penalized as severely during the downturn. Nevertheless, in light of poor economic conditions and the performance of FINRA's investments, Ms. Schapiro recommended, and the Compensation Committee agreed, that 2009 base salaries for senior management should be frozen at 2008 levels[239] and that incentive compensation for 2008 should be 25% less than that paid for 2007.[240]

b. Consideration to Performance

When making senior management compensation decisions, the Compensation Committee (and, with respect to the chief executive officer's compensation, the Board) factored into its decision-making the performance of the individual and FINRA in general.[241] In 2007, the Compensation Committee took into account the work integrating NYSE Regulation into FINRA. In 2008, the Compensation Committee took into consideration the market decline and senior management's increased workload.

The Demand Letter implies that the Compensation Committee and Board should have reduced the compensation of the members of senior management for their performance with respect to the alleged oversight failures of Bear Stearns, Lehman Brothers, Merrill Lynch, Bernard Madoff, Ross Mandel and Stanford Financial Group.[242] The Demand Letter alleges that,

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239 11/17/08 Comp. Cmte. Minutes at 2.

240 01/08/09 Comp. Cmte. Minutes at 2.

241 Compensation Philosophy at Section II.

242 Demand Letter at 3-4.

notwithstanding these alleged oversight failures, senior management's compensation was increased to its highest levels.[243]

According to interviews with members of the Compensation Committee and Board, when information about the alleged oversight failures was known, that information was considered by the Board and Compensation Committee in making compensation decisions. Such analysis was not required for many members of senior management because they were not in positions that would have contributed to the alleged oversight failures.

Little reliable information was known about the alleged oversight failures when the Compensation Committee determined the 2008 incentive compensation and 2009 base salaries for senior management. The results of FINRA's review of its examination program with respect to Madoff and Stanford were not available until September 2009. This information was factored into the decisions relating to 2009 incentive compensation and 2010 base salary.

c. Comparison Group

As described above, benchmarking was an integral part of the process for determining senior management compensation. Finding appropriate benchmarking comparables presented a significant challenge for FINRA because of the scarcity of natural comparators, the uniqueness of FINRA's function, FINRA's need for specialized expertise concerning financial services and securities law and the constantly changing environment that is subject to heightened scrutiny by Congress, the SEC, its members and the public.[244]

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243 Demand Letter at 3-4. The Demand Letter's assertion is not factually accurate. Base salaries were frozen for 2009, and 2008 incentive compensation was 25% lower than 2007 incentive compensation. 01/08/09 Comp. Cmte. Minutes at 2.

244 Compensation Philosophy at Sec. I.

In light of this challenge, FINRA retained Mercer in 2004 to aid in revising and memorializing FINRA's compensation strategy. Mercer first sought to understand the types of organizations with which FINRA competed for employees. Representatives from Mercer met with FINRA's management to get a sense of where employees, including members of management, had previously worked, and where they were going when they left FINRA. Mercer ultimately determined that most of FINRA's employees and management had come from and were leaving to the financial services industry. Mercer also noted that FINRA's role as a complex private sector regulator required a pool of executive talent with the knowledge and skills similar to those in the financial services industry.[245]

Mercer and the Compensation Committee therefore concluded that, because FINRA competed primarily with the financial services industry for talent, the financial services industry, including broker-dealers, global investment banks, Federal Reserve banks, commercial banks and insurance companies, would provide the best benchmarks for senior management compensation.[246] They also concluded that non-profit organizations and governmental agencies were inadequate comparables for compensation purposes because FINRA required of its executives a different skill set and knowledge base than many such organizations.[247] In addition to advising the Compensation Committee on selecting appropriate comparison groups, Mercer provided advice about selecting comparable institutions within those comparable groups.

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245 2004 Mercer Comp. Report at 6.

246 Compensation Philosophy.

247 Compensation Philosophy at Sec. I; 2004 Mercer Comp. Report at 7 ("Demands and skills required of [FINRA] leadership as a leading private sector regulator of the financial services community is different from the skill sets required of most not-for-profit entities and smaller exchanges.").

d. Reliance on Mercer for Data

The Compensation Committee and Board relied upon Mercer to gather, analyze and present data as part of Mercer's comparables analysis. Mercer is one of the world's largest and most reputable compensation consulting firms, with 19,000 employees serving clients in over 180 cities and 40 countries. Members of the Compensation Committee stated during their interviews that they had no reason to believe that Mercer's data and analyses were unreliable.

In preparing its analysis, Mercer did the following. Mercer worked with management to obtain information about each incumbent executive's base salary, incentive compensation, bonus target, title and job responsibilities. Mercer then gathered market data on base, incentive and long-term compensation for individuals with similar titles and responsibilities at comparable organizations and compared the data to that received from FINRA.

As comparables for the compensation of FINRA's chief executive officer and chief financial officer, Mercer used investment banking and brokerage firms with between $250 million and $5.6 billion[248] of revenue because the pay level of chief executive officers and chief financial officers are generally related to firm size. Data for those comparables was collected from the proxy statements and other public filings of the comparison group companies and for the NYSE's chief executive officer.[249]

For other senior executives, it was more difficult to match FINRA executives with their counterparts at other organizations because there were not always exact title matches. Mercer therefore attempted to match FINRA executives with their peers by using the information it

248 In November 2008, Mercer used investment banking and brokerage firms with no more than $5.6 billion in revenue. For its December 2007 review, it used firms with no more than $5 billion in revenue, and in its February 2007 review it used firms with no more than $3.2 billion in revenue.

249 02/01/07 Mercer Report at 14.

obtained about the FINRA executives' responsibilities and attempting to find positions with matching responsibilities at comparable organizations. When a close match in positions could not be found, Mercer stated in its reports that no data was available, rather than trying to force an inadequate comparison.

To obtain data on the comparables (other than for chief executive officer and chief financial officer), Mercer used McLagan's surveys because they were considered to be the best products and included the most comparable organizations. Mercer used the following McLagan Surveys: Communications and Marketing, Corporate General Services, Finance and Business, Human Resources, Information Technology, Legal and Compliance, Management and Administration, and Operations."[250] Participants in these surveys included investment management companies, advisory firms, Wall Street firms and other small and large capital markets business/financial services organizations.[251] Mercer did not focus on firms of a certain size (other than for chief executive officer and chief financial officer) because Mercer had concluded from its experience that the lower the level of management, the less relevant the size of the organization became for compensation purposes. Additionally, Mercer was concerned that limiting comparators to firms of a specific size would unduly limit the number of comparables available.

Because compensation surveys and public filings typically reported pay for the prior year, Mercer applied an aging factor to the data it collected to account for the fact that the data was a year old. The aging factor was based on Mercer's own analysis of compensation trends. After analyzing comparable data, Mercer prepared its report and presented its analysis to

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250 02/01/07 Mercer Report at 9.

251 02/01/07 Mercer Report at 9.

management and the Compensation Committee. Mercer also provided forward-looking data and information about compensation trends to further assist with compensation decisions.

Each time it presented its analysis of the data it collected, Mercer informed the Compensation Committee that market data was a frame of reference only, and that the Compensation Committee therefore would need to apply its independent judgment to determine the level of pay necessary to properly compensate senior management.

e. Update to Comparison Group

Although the Compensation Committee had concluded that the financial services industry was the best comparables group, comparables were a topic of discussion for the Compensation Committee and it requested that Mercer provide data for additional comparables to ensure that it had sufficient information.

At the December 3, 2007 Compensation Committee meeting, the Compensation Committee requested that Mercer include in its analysis compensation data from exchanges and regulators such as the Depository Trust and Clearing Corporation.[252] Ms. Schapiro agreed to contact such entities as the Chicago Board Options Exchange, the Depository Trust and Clearing Corporation, the New York Stock Exchange and the New York Mercantile Exchange to obtain compensation data.[253]

For the January 14, 2008 Compensation Committee meeting, the Committee package included the additional information requested at the last meeting via an updated report from Mercer.[254] It benchmarked the 2006 compensation awarded to Ms. Schapiro and Mr. Diganci

252 12/03/07 Comp. Cmte. Minutes at 2.

253 12/03/07 Comp. Cmte. Minutes at 2.

254 01/08 Mercer Report.

against peers at the Chicago Board of Options Exchange, CME Group (recently combined with CBOT), International Securities Exchange Holdings, Inc., Nasdaq Stock Market, Inc., NYFIX, Inc., NYMEX Holdings, Inc. and NYSE Euronext.[255] Information from the Depository Trust & Clearing Corp. was apparently provided separately and confidentially.[256]

Mercer concluded that total direct compensation for FINRA's chief executive officer was "very consistent among the two groups examined at both the median and 25th percentile levels."[257] Ms. Schapiro's total cash compensation was $2.5 million, compared with the median (excluding long-term incentives) of $2.1 million and 75th percentile of $3.3 million.[258] Including the long-term incentives, Ms. Schapiro's total direct compensation remained at $2.5 million, but total direct compensation for the comparable group rose to $5.4 million for the median and $6.5 million for the 75th percentile.[259]

Mercer also concluded that total direct compensation for FINRA's chief financial officer was "consistent with the previously presented market results."[260] Total cash compensation for Mr. Diganci was $1.09 million versus the median (excluding long-term incentives) of $726,000 and 75th percentile of $963,000.[261] When long-term incentives were considered, Mr. Diganci's compensation remained at $1.09 million while the median total compensation for comparables rose to $1.4 million and a 75th percentile of $1.9 million.[262]

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[255] 01/08 Mercer Report at 4-7.

[256] 01/08 Mercer Report at 2.

[257] 01/08 Mercer Report at 3.

[258] 01/08 Mercer Report at 5.

[259] 01/08 Mercer Report at 5.

[260] 01/08 Mercer Report at 7

[261] 01/08 Mercer Report at 7.

[262] 01/08 Mercer Report at 7.

After its January 2008 update, Mercer continued to provide data from exchanges and regulators, along with data from the financial services industry, in its comparables analysis for subsequent reports.[263] A few years later, to ensure that the financial services industry and exchanges and regulators remained the most appropriate comparables, the Compensation Committee asked Mercer to also examine reference data for law firms, the SEC and not-for-profit organizations. Mercer's analysis showed that (1) FINRA's target total compensation range for lawyers was consistent with the market place, (2) comparisons to the SEC were difficult given the federal government pay ranges and the fact that FINRA management's attraction and/or flight risk to the SEC were for reasons other than compensation[264] and (3) not-for-profit data showed that there was no direct link between the size and complexity of associations with respect to pay for top executives and that few such organizations compared with FINRA's unique characteristics.[265] Mercer concluded that financial services organizations and exchanges/regulators remained the most appropriate comparables for senior management compensation.[266]

3. SERP

a. Impact on Comparisons to Benchmarks

Mercer's benchmark analysis of total direct compensation did not include senior management's SERP benefits. Nor did Mercer prepare or provide analysis comparing the SERP at FINRA to that of the comparable organizations. Mercer did not compare FINRA's SERPs to

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263 11/08 Mercer Report at 11-12; 11/08/09 Mercer Report at 12.

264 Those reasons included the challenge of the role, the chance to make policy contributions, the opportunity to gain experience and the enhancement of future career opportunities. 01/27/10 Mercer Report at 3.

265 01//27/10 Mercer Report.

266 01//27/10 Mercer Report at 1.

those of other organizations because sufficient information from other organizations was not available.

The Compensation Committee (and, with respect to the compensation of the chief executive officer, the Board) nevertheless did review and take into account the value of the SERPs when approving senior management compensation. The Compensation Committee and Board understood that the annual increase in the value of the SERP benefits had only a modest impact on the value of total compensation and therefore generally did not substantially affect the comparisons to benchmarks. The Committee confirmed that, even when the value of the SERPs are added to the total direct compensation of the members of senior management, their compensation generally remained below to modestly above the 50th percentile when compared to the total direct compensation of the comparable groups.

4. Mary Schapiro's Compensation On Departure

The Demand Letter suggests that, when Mary Schapiro left FINRA, she was awarded a "going away" gift valued as high as $25 million.[267] The actual value of the final distribution to Ms. Schapiro was $8,985,334.02.[268] The vast majority of this payment was non-discretionary. Her vested retirement benefits accounted for $7.6 million of the payment.[269] Another $100,000 consisted of wages and accrued vacation payout.[270]

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267 Demand Letter at 5.

268 A table entitled Final Distributions Worksheet, which sets forth the components of the final distribution to Ms. Schapiro, is attached to this report at Exhibit F.

269 Final Distributions Worksheet, Ex. F. Ms. Schapiro's retirement benefits were paid in a lump sum. The amount of the lump sum payment due to Ms. Schapiro was calculated by FINRA's retirement benefit consultant, AON Consulting, in accordance with standard practices for calculating such benefits.

270 Final Distributions Worksheet, Ex. F.

The additional $1.3 million was incentive compensation for 2008.[271] Under the terms of her employment agreement, she was entitled to an incentive compensation of at least between $1 million and $1.25 million.[272] The additional $50,000 represented a $425,000 reduction from the prior year.[273]

C. Conclusion

The Committee concludes that FINRA has no genuine basis to claim that the members of the Compensation Committee or Board acted in bad faith in awarding the compensation paid to senior management in 2007, 2008 and 2009.[274] FINRA cannot genuinely claim that such

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271 Final Distributions Worksheet, Ex. F. The Demand Letter also stated that, "without the slightest legal or factual justification," Ms. Schapiro's "total annual base compensation was increased by 57% from $1,999,731 to $3,140,826 plus the value of indirect benefits not readily determinable." Demand Letter at 5. The dollar figures cited in the Demand Letter represent the combined value of Ms. Schapiro's salary, incentive compensation, employee benefit plan contributions and expense account allowances for 2006 and 2007, respectively. The Committee has determined that the increase in Ms. Schapiro's total compensation primarily was the result of Ms. Schapiro's promotion to chief executive officer in September 2006. Additionally, members of the Compensation Committee explained during their interviews that Ms. Schapiro and certain other members of senior management received increased incentive compensation for 2007 in recognition of their work integrating NYSE Regulation into FINRA.

272 Schapiro Employment Contract at Sections 3-4.

273 01/08/09 Comp. Cmte. Minutes at 3. Although the Board could, in theory, have awarded Ms. Schapiro only the contractual minimum of 2008 incentive compensation to which she was entitled, the Board was concerned about how such a precedent would be viewed by current and potential future members of management.

274 The Committee has also considered whether FINRA has a viable claim for fraud or negligent misrepresentation against any member of the Board, Compensation Committee, management or FINRA's compensation advisors. The Committee has found no evidence that would plausibly support an argument that, with respect to senior management compensation, the members of the Board, Compensation Committee, management or FINRA's compensation advisors made a false statement, supplied false information to FINRA or failed to exercise reasonable care in obtaining or communicating information. The Committee

members intentionally failed to "act in the face of a known duty to act" or demonstrated a "conscious disregard" for their duties.

The facts rather show that the members of the Board and Compensation Committee took seriously their duties and acted with the goal of awarding a reasonable and appropriate amount of compensation to senior management. The members retained and received analysis from a reputable compensation advisor. They sought to ensure that appropriate comparables were found and that the compensation of senior management was reasonable when compared to those comparables. The facts uncovered by the investigation show that serious individuals endeavored diligently to award senior management compensation that was not excessive yet was sufficient to meet FINRA's goal of retaining talented individuals.

IV. PROPOSED CLAIMS FOR BREACH OF THE FIDUCIARY DUTY OF CARE

The Committee was advised as follows concerning the law applicable to claims that the members of the Board and Compensation Committee breached their duties of care in approving the compensation of senior management between 2007 and 2009. Delaware law accords great deference to management compensation decisions made by boards/committees.[275] Delaware

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therefore has concluded that, with respect to senior management compensation, FINRA does not have a viable claim for fraud or negligent misrepresentation.

The Committee has also considered whether FINRA might have a viable claim for aiding and abetting a breach of fiduciary duty against any member of the Board, Compensation Committee, management or FINRA's compensation advisors. The Committee was advised by counsel that a viable claim for aiding and abetting a breach of fiduciary duty arises only where a breach of fiduciary duty has occurred. *Malpiede*, 780 A.2d at 1096. As the Committee has determined that, with respect to compensation decisions, no breach of fiduciary duty occurred, it has concluded that FINRA does not have a viable claim for aiding and abetting a breach of fiduciary.

[275] *See Official Comm. of Unsecured Creditors of Integrated Health Servs. v. Elkins*, 2004 Del. Ch. LEXIS 122, at *65 (Del. Ch. Aug. 24, 2004) ("[W]hen dealing with

courts have explained that the question of "how much is too much" is "far better suited to the boardroom than the courtroom."[276] Thus, the members of the Board and Compensation Committee would be liable for a breach of their duties of care only if their decision-making process in arriving at a decision was grossly negligent.[277] Additionally, the Committee was advised that the members of the Board and Compensation Committee are exculpated from monetary liability for breaches of the duty of care pursuant to the exculpation provision in FINRA's certificate of incorporation.[278]

The Committee has determined that FINRA does not have a viable claim against the members of the Board or Compensation Committee for breach of their duties of care because the Board and Compensation Committee made decisions after carefully considering information provided by a reasonably-selected advisor.[279] The Committee has further determined that

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a board's decision on executive compensation, its substantive decision is entitled to great deference."); *In re Pennaco Energy, Inc. Shareholders Litig.*, 787 A.2d 691, 708 (Del. Ch. 2001) ("Historically, Delaware courts have been quite reluctant to second-guess compensation decisions made by boards[.]"); *Sullivan v. Hammer*, 1990 Del. Ch. LEXIS 119, at *18 (Del. Ch. Aug. 7, 1990) ("While there is a limit to executive compensation, courts have always been hesitant to substitute their judgment for the directors in ascertaining whether executive compensation is rational.").

276 *In re infoUSA, Inc. S'holders Litig.*, 953 A.2d 963, 983 (Del. Ch. 2007). *See also Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000) (*quoting In re The Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 362 (Del. Ch. 1998)) ("It is the essence of business judgment for a board to determine if "a 'particular individual warrant[s] large amounts of money, whether in the form of current salary or severance provisions.'").

277 *Van Gorkom*, 488 A.2d at 873; *Aronson*, 473 A.2d at 812.

278 *See supra* note 171.

279 In conjunction with its analysis of potential fiduciary duty claims, the Committee investigated whether a claim could be made against the members of the Board or Compensation Committee for corporate waste. The Committee was advised by counsel on the law concerning corporate waste as follows. Corporate waste is an "exchange that is so one sided that no business person of ordinary, sound

FINRA does not have a viable breach of the fiduciary duty of care claim because the exculpation provision would exculpate the members of the Board and Compensation Committee from monetary liability.

V. PROPOSED CLAIMS AGAINST OTHERS

A. Proposed Claims Against Management

The Committee considered whether FINRA might have claims against members of management for unjust enrichment. Counsel provided the following advice to the Committee concerning unjust enrichment. Unjust enrichment occurs when a person receives a benefit at another's expense, and the enriched person's retention of the benefit would be unconscionable.[280] A viable unjust enrichment claim arises only where there is an "absence of justification for the transfer that enriches one party and impoverishes the other."[281]

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judgment could conclude that the corporation has received adequate consideration." *Brehm*, 746 A.2d at 263. A decision should be considered a waste of corporate assets only if the decision was "so egregious or irrational that it could not have been based on a valid assessment of [FINRA's] best interests." *White v. Panic*, 783 A.2d 543, 554 (Del. 2001). The Delaware Court of Chancery has indicated that it is very rare – "indeed, like Nessie, possibly non-existent" – for a decision to be considered a waste of corporate assets if the decision was made in good faith by a disinterested and independent committee or board. *Telxon Corp. v. Bogomolny*, 792 A.2d 964, 975-976 (Del. Ch. 2001).

As described in this report, the Committee has determined that the Board and Compensation Committee were disinterested and independent and made management compensation decisions in good faith and with due care. Additionally, the Committee has reviewed the compensation awarded to individual members of senior management and has determined that the amounts awarded were neither egregious nor irrational. The Committee therefore has concluded that FINRA does not have a viable claim of corporate waste against the Board or Compensation Committee.

280 *Schock v. Nash*, 732 A.2d 217, 233 (Del. 1999).

281 *Terr. of the U.S. V.I. v. Goldman, Sachs & Co.*, 937 A.2d 760, 796 (Del. Ch. 2007).

Although restitution of an unjustly obtained benefit can be ordered by a court even where the enriched party was not itself a wrongdoer,[282] the "absence of justification" requirement "usually entails some type of wrongdoing or mistake at the time of the transfer."[283] Thus, unjust enrichment is normally "deployed against persons who (although not acting [wrongfully] themselves) are sufficiently aligned with a wrongdoer that they ought to disgorge an unearned benefit conferred upon them by the wrongdoer at the victim's expense."[284]

Additionally, an unjust enrichment claim is not permitted under Delaware law where an agreement governs the transfer in issue.[285] "The logic behind [this rule] is simple: if a contract covers the subject matter, the defendant's conduct either violates the contract or not. If the defendant did not violate the contract governing the subject of the dispute, then the plaintiff cannot attempt to . . . obtain a better bargain than he got during the contract negotiations."[286]

As described above, the Committee has determined that the members of the Board and Compensation Committee, in approving management compensation in 2007, 2008 and 2009, acted in good faith, without any improper interest or lack of independence, and with proper care.

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282 *Schock*, 732 A.2d at 233; *Hills Stores Co. v. Bozic*, 769 A.2d 88, 110 n.74 (Del. Ch. 2000) ("Just as someone can't keep a mistakenly excessive tax refund or automatic teller pay out, these defendants cannot hold on to overpayments from the company to which they owed fiduciary duties.").

283 *Goldman, Sachs*, 937 A.2d at 796.

284 *Teachers' Ret. Sys. of La. v. Aidinoff*, 900 A.2d 654, 673 n.25 (Del. Ch. 2006).

285 *Reserves Dev. LLC v. Severn Sav. Bank*, 2007 Del. Ch. LEXIS 156, at *35-36 (Del. Ch. Nov. 9, 2007) ("If there is a contract between the complaining party and the party alleged to have been enriched unjustly that governs the matter in dispute, then the contract remains 'the measure of [the] plaintiff's right.'"); *ID Biomedical Corp. v. TM Techs.*, 1995 Del. Ch. LEXIS 34, at *39 (Del. Ch. Mar. 16, 1995) (same).

286 *Ameristar Casinos, Inc. v. Resorts Int'l Holdings, LLC*, 2010 Del. Ch. LEXIS 107, at *39 (Del. Ch. May 11, 2010).

The Committee also reviewed the compensation awarded to the members of senior management and determined that the amounts awarded were reasonable and justified. The Committee further determined that the majority of the compensation received by Mary Schapiro when she left FINRA was required by her employment agreement and was not otherwise unreasonable.[287] Based on those findings, the Committee has determined that FINRA does not have a genuine claim against the current and former members of senior management for unjust enrichment.

B. Proposed Claims Against Mercer

Counsel advised the Committee that Mercer most likely did not owe fiduciary duties to FINRA.[288] Counsel further advised the Committee that, to determine whether FINRA might have a negligence claim against Mercer, FINRA would need to establish facts showing that Mercer's advice was inconsistent with and unreasonable compared to advice given by compensation consultants generally.[289]

In evaluating whether Mercer acted negligently, the Committee and/or its counsel reviewed the analyses, presentations and reports prepared by Mercer. It interviewed members of the Compensation Committee and management about Mercer's performance. It interviewed representatives from Mercer. The Committee's investigation did not reveal any facts that

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287 *See MCG Capital Corp. v. Maginn*, 2010 Del. Ch. LEXIS 87, at *90 (Del. Ch. May 5, 2010) (finding that an unjust enrichment claim could not be used to challenge increases in the compensation of executives because the executives' employment agreements granted the board authority and discretion to increase the salaries or bonuses of the executives and explicitly required the board to periodically review whether an increase was warranted).

288 *See supra* note 203. Mercer did not have authority to make decisions on FINRA's behalf.

289 *Gallo*, 2008 Del. Super. LEXIS 106, at *10 (explaining that a professional's "conduct and competency is evaluated against others who possess similar skills, expertise, training and knowledge").

plausibly could support a claim that the advice provided by Mercer deviated from industry standards.

C. Proposed Claims Against FINRA's Counsel

The Committee investigated whether FINRA might have any claims against its legal counsel relating to senior management compensation. The investigation revealed that FINRA's counsel did not have any significant involvement in management compensation decisions. The Committee has determined there is nothing to support a claim against FINRA's counsel relating to the senior management compensation paid in 2007, 2008 or 2009.

OTHER CONSIDERATIONS

In making its recommendations, the Committee has also considered a number of factors not expressly addressed above, including (1) the likelihood that, even if FINRA did have viable claims, claims relating to decisions made during the earlier years may be barred by the applicable limitations period,[290] (2) the likelihood that claims for monetary relief against governors and former governors of FINRA arising from asserted breaches of the fiduciary duty of care would be barred by the exculpation provision in FINRA's certificate of incorporation,[291] and (3) the cost and distraction associated with asserting meritless claims against current and former members of FINRA's Board, Committees, outside advisors and counsel.

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290 *See supra* note 19.

291 *See supra* note 171.

http://www.finra.org/AboutFINRA/Leadership/Committees/P122215

EXHIBIT A

FINRA Investments

Since Inception Analysis [1]

($ Millions)

Beginning Balance 12/31/03	$	**1,149**
Nasdaq Proceeds		892.0
Investment Returns, net		252.0
Special Rebate (NYSE merger)		(51.9)
Member Rebates		(326.5)
Operating Budget Support		(293.0)
All Other		(34.4)
Portfolio Balance 12/31/09	$	**1,587**

($ Millions)

FINRA Investment Returns

	2004	2005	2006	2007	2008	2009 [2]	Cumulative '04-'09
Total return	$49.3	$83.9	$249.5	$233.1	($567.5)	$203.8	$252.0
Total return (%)	7.2%	7.4%	12.9%	8.5%	(26.5%)	13.7%	
Portfolio balance 12/31	$1,300.6	$1,726.8	$2,360.7	$2,240.5	$1,565.3	$1,586.9	
Nasdaq Proceeds	0.1	444.2	447.7				$892.0
Special Rebate (NYSE merger)				(51.9)			($51.9)
Member Rebates	(30.0)	(50.0)	(50.0)	(184.7)	(5.9)	(5.9)	($326.5)
Operating Budget Support	128.0	32.3	(90.3)	(114.4)	(146.9)	(101.7)	($293.0)
All Other	4.6	(84.3)	77.0	(2.3)	45.1	(74.5)	($34.4)

Portfolio balance 12/31	$1,300.6	$1,726.8	$2,360.7	$2,240.5	$1,565.3	$1,586.9
Total return (%)	7.2%	7.4%	12.9%	8.5%	(26.5%)	13.7%

	2004	2005	2006	2007	2008	2009	Annualized 2004-2009
S&P500	10.9%	4.9%	15.8%	5.5%	(37.0%)	26.5%	2.1%
Barclays US Agg	4.3%	2.4%	4.3%	7.0%	5.2%	5.9%	4.9%
Citigroup Treasury Bill-3 Month	1.2%	3.0%	4.8%	4.7%	1.8%	0.2%	2.6%
FINRA	7.2%	7.4%	12.9%	8.5%	(26.5%)	13.7%	2.8%

[1] Analysis based on unaudited management reports

[2] 2009 figures are based upon preliminary results

EXHIBIT B

FINRA Portfolio Performance v. Benchmark: Year 2003			
Month	**FINRA Performance**	**Benchmark**	**Difference**
January 2003	-0.29%	-0.43%	0.14%
February 2003	0.59%	0.41%	0.18%
March 2003	0.13%	0.14%	-0.01%
April 2003	2.04%	2.08%	-0.04%
May 2003	2.33%	2.25%	0.08%
June 2003	0.18%	0.30%	-0.12%
July 2003	-1.42%	-0.92%	-0.50%
August 2003	1.14%	0.73%	0.41%
September 2003	1.19%	1.25%	-0.06%
October 2003	0.81%	0.79%	0.02%
November 2003	0.61%	0.45%	0.16%
December 2003	1.43%	1.50%	-0.07%
Year 2003	9.01%	8.84%	0.17%

FINRA Portfolio Performance v. Benchmark: Year 2004			
Month	**FINRA Performance**	**Benchmark**	**Difference**
January 2004	0.85%	0.75%	0.10%
February 2004	0.86%	0.89%	-0.03%
March 2004	0.34%	0.32%	0.02%
April 2004	-1.66%	-1.84%	0.18%
May 2004	0.14%	0.06%	0.08%
June 2004	-0.97%	-1.08%	0.11%
July 2004	-1.53%	-1.65%	0.12%
August 2004	0.27%	0.57%	-0.30%
September 2004	0.07%	0.13%	-0.06%
October 2004	1.32%	1.63%	-0.31%
November 2004	3.51%	3.41%	0.10%
December 2004	2.73%	2.48%	0.25%
Year 2004	7.21%	7.24%	-0.03%

FINRA Portfolio Performance v. Benchmark: Year 2005			
Month	**FINRA Performance**	**Benchmark**	**Difference**
January 2005	-1.22%	-1.16%	-0.06%
February 2005	1.96%	1.68%	0.28%
March 2005	-0.74%	-0.76%	0.02%
April 2005	-1.46%	-1.21%	-0.25%
May 2005	1.96%	1.85%	0.11%
June 2005	1.40%	1.04%	0.36%
July 2005	2.88%	2.31%	0.57%
August 2005	0.41%	0.54%	-0.13%
September 2005	1.04%	1.04%	0%
October 2005	-2.11%	-1.18%	-0.93%
November 2005	2.38%	1.99%	0.39%
December 2005	1.62%	1.31%	0.31%
Year 2005	7.43%	6.47%	0.94%

FINRA Portfolio Performance v. Benchmark: Year 2006			
Month	**FINRA Performance**	**Benchmark**	**Difference**
January 2006	3.49%	3.09%	0.40%
February 2006	0.09%	0.22%	-0.13%
March 2006	5.26%	5.22%	0.04%
April 2006	2.02%	1.40%	0.62%
May 2006	-2.42%	-1.90%	-0.52%
June 2006	-0.63%	-0.34%	-0.29%
July 2006	0.22%	0.27%	-0.05%
August 2006	1.55%	1.71%	-0.16%
September 2006	0.11%	0.92%	-0.81%
October 2006	2.50%	2.41%	0.09%
November 2006	2.46%	1.70%	0.76%
December 2006	0.81%	1.07%	-0.26%
Year 2006	12.92%	13.70%	-0.78%

FINRA Portfolio Performance v. Benchmark: Year 2007			
Month	**FINRA Performance**	**Benchmark**	**Difference**
January 2007	1.11%	1.10%	0.01%
February 2007	0.21%	0.09%	0.12%
March 2007	1.21%	1.05%	0.16%
April 2007	2.53%	2.20%	0.33%
May 2007	N/A[1]	N/A	N/A
June 2007	-0.44%	0.07%	-0.51%
July 2007	-0.92%	-0.42%	-0.50%
August 2007	-0.09%	-0.31%	0.22%
September 2007	3.15%	3.21%	-0.06%
October 2007	2.77%	2.69%	0.08%
November 2007	-2.99%	-1.97%	-1.02%
December 2007	-0.43%	-0.32%	-0.09%
Year 2007	8.46%	10.07%	-1.55%

[1] Monthly data not available for May 2007.

FINRA Portfolio Performance v. Benchmark: Year 2008			
Month	**FINRA Performance**	**Benchmark**	**Difference**
January 2008	-3.96%	-4.00%	0.04%
February 2008	0.45%	0.58%	-0.13%
March 2008	-2.01%	-0.93%	-1.08%
April 2008	2.86%	2.76%	0.10%
May 2008	1.46%	1.13%	0.33%
June 2008	-4.35%	-3.86%	-0.49%
July 2008	-2.60%	-1.48%	-1.12%
August 2008	-1.31%	-0.94%	-0.37%
September 2008	-9.05%	-6.88%	-2.17%
October 2008	-12.91%	-10.49%	-2.42%
November 2008	-4.51%	-2.47%	-2.04%
December 2008	2.25%	2.13%	0.12%
Year 2008	-30.15%	-22.68%	-7.47%

FINRA Portfolio Performance v. Benchmark: Year 2009			
Month	**FINRA Performance**	**Benchmark**	**Difference**
January 2009	-2.83%	-3.33%	0.50%
February 2009	-3.96%	-3.42%	-0.54%
March 2009	3.07%	3.35%	-0.28%
April 2009	5.51%	4.29%	1.22%
May 2009	5.84%	3.61%	2.23%
June 2009	N/A[2]	N/A	N/A
July 2009	2.7%	5.4%	-2.7%
August 2009	1.5%	2.2%	-0.7%
September 2009	1.9%	2.5%	-0.6%
October 2009	0.5%	0.0%	0.5%
November 2009	1.2%	2.1%	-0.9%
December 2009	0.2%	-0.1%	0.3%
Year 2009	16.9%	17.7%	-0.8%

[2] Monthly data not available for June 2009.

EXHIBIT C

FINRA's Employees Retirement Plan – Defined Benefit

Feature	Qualified
Earnings Feature	Base pay,subject to IRS limits of $245,000 for 2009 (indexed thereafter).
Final Average Earnings	Average of highest consecutive 5 years of base pay.
Benefit Accrual	1.25% of final average earnings plus .5267% of final average earnings in excess of covered compensation for each year of service after 1/1/89 (prior offset formula used before 1/1/89).
Vesting	100% after 5 years of service.
Normal Retirement	Age 65 with 5 years of participation
Early Retirement	Age 55 with 10 years of service.
Early Payment Reduction	If age 55 with 10 years of service, 3% per year prior to age 62 (age 65 for employees after 2006). If under age 55 with at least 10 years of service, 5% per year from age 65 to age 55 and actuarial from age 55. If under age 55 with less than 10 years of service, actuarial from age 65.
Preretirement Death Benefit	Lump sum equal to 100% of present value of accrued benefit.
Payment Options	Life annuity, joint & survivor, certain and life, and certain only options. A lump sum option is also available. Lump sums can be rolled over to an IRA or another qualified plan within 60 days of payment.
Protection of Assets	Qualified Plan Trust – assets currently total $145.5 million

EXHIBIT D

FINRA
Executive Retirement Plan (DB SERP)

	Executive Vice Presidents (EVPs) with Employment Agreements	Executive Vice Presidents (EVPs)	Senior Vice Presidents (SVPs)
Participants	4	11	9
Vesting Schedule	50% after 5 years of service; 10% per year thereafter (100% after 10 years)	Age 55 plus 10 years of service	Age 55 plus 10 years of service
Eligible Compensation	Base salary + 1/3 of earned incentive compensation	Base salary + 1/3 of earned incentive compensation	Base salary + 1/3 of earned incentive compensation
Final Average Compensation (FAC)	Five years base pay plus 1/3 incentive compensation (for last 5 calendar years) weighted 5/4/3/2/1 divided by 15	Average of highest base salary for 60 consecutive months of employment plus 1/3 of earned incentive compensation for last 5 calendar years prior to retirement	Average of highest base salary for 60 consecutive months of employment plus 1/3 of earned incentive compensation for last 5 calendar years prior to retirement
Benefit Accrual	Same as EVPs except benefit equivalent to age 55 if retire before age 55	6% per of service up to 10 to a maximum of 60% of FAC	4% per year of service up to 15 to a maximum of 60% of FAC
Offsets	Same as EVPs	Reduced by the annual benefit provided under the qualified Retirement Plan	Reduced by the annual benefit provided under the qualified Retirement Plan and estimated Social Security benefits
Early Retirement Calculation	Benefit equivalent to age 55 if retire before age 55; no reduction of benefit on or after age 62; 3% reduction per year between age 55 and 62	Age 55 and 10 years of service. No reduction of benefit on or after age 62; 3% reduction per year between age 55 and 62.	Same as EVP
Taxes	Same EVPs	The SERP amount is taxed when participant is vested. The plan will make an advance payment to cover taxes due. Advance taxes, including a 7% per year interest factor, are offset against final retirement payment	The SERP amount is taxed when participant is vested. The plan will make an advance payment to cover taxes due. Advance taxes, including a 7% per year interest factor, are offset against final retirement payment
Funding Status	Rabbi Trust [1/]	Rabbi Trust [1/]	Rabbi Trust [1/]

[1/] Total assets are $15.7 million invested in Alliance/Bernstein 2015 Retirement Strategy Fund

EXHIBIT E

FINRA Executive Retirement Plan – Defined Contribution (DC SERP)

The SDCP is completely funded by FINRA and is intended to provide certain executives with supplemental retirement income.

Feature	
Eligible Participants (currently 47 officers)	Chief executive officer Senior executive and executive vice presidents Senior vice presidents Vice presidents whose base salaries exceed the qualified plan compensation limit (the compensation limit is $245,000 for 2009, and is subject to change each year by the federal government).
Eligible Compensation	Senior vice presidents and above – Current base pay plus one-third annual incentive compensation (awarded in current year for prior year). Vice president – Current base pay only
Company Contributions (% of eligible compensation)	Chief executive officer: 20% Senior executive and executive vice presidents: 16% Senior vice presidents: 12.5% Vice presidents: 5%
Vesting Schedule	Contributions vest and are taxed in three-year steps. Three years of contributions and earnings vest at the end of year three, year six, etc. All non-vested contributions will vest at age 62, death or termination of employment after disability.
Investment Options	Investments are "self-directed" by the executives. Generally, the same fund options as for the 401(k) Plan (with the exception of a Money Market Fund in lieu of the Retirement Savings Trust).
Loans	Not permitted
Withdrawals	One withdrawal type permitted (not subject to 10% excise tax penalty): Unforeseeable emergency withdrawals (very limited)
Payout Options	Lump sum or annual installments up to 20 years
Rollover/Transfers into or out of the Plan	Not permitted
Protection of Assets	Rabbi trust (currently $4.2 million)

EXHIBIT F

Final Distributions - Mary L. Schapiro
January 23rd, 2009

Distribution on 1/20/09	SERP	ERP	2008 IC Payout	Reg Wages 1-11 - 1-23 *	Vacation Payout **	Payment for Three Months COBRA	Totals for Final Distributions on 1/23/09	
Gross	7,289,917.49	304,145.00	1,300,000.00	38,461.54	45,855.77	6,954.22	8,985,334.02	
Taxable Gross	5,781,375.05		1,289,269.24	30,384.61	45,855.77	6,954.22	7,153,838.89	
Fed Tax	1,923,481.27		451,244.23	10,890.36	11,463.94	2,434.08	2,399,513.89	
Medicare	83,829.94		18,850.00	557.69	664.91	100.84	104,003.38	
DC Tax	491,416.88		109,588.00	2,525.00	3,898.00	591.00	608,018.88	
NY Tax			-	-	-		-	
401(k)			-	6,153.85			6,153.85	1
457			10,730.76	1,923.08			12,653.84	2
America's Charity			-	250.00			250.00	
							-	
Total Deductions	2,498,728.09		590,412.99	22,299.98	16,026.85	3,125.92	3,130,593.83	
							-	
Actual Net Pay	4,791,189.40	304,145.00	709,587.01	16,161.56	29,828.92	3,828.30	5,854,740.19	
Payment Method	Mailed from Mellon on 1/23/09	TBD	Wire to current direct deposit account on 1/23/09					

** Vacation pay out on final check is 80 hours plus 15.38 hour accrual from PPE 01-10-09 and 01-24-09

* No benefits on third check of month

1 401k Contribution is 16%

2 457 Contribution is 5%

F:\Payroll\Mary\MLS Final Payout 1 23 09 update 7.8.10.xlsx