

# Special Notice to Members

APRIL 6, 2004

## SUGGESTED ROUTING

Executive Representatives  
Legal & Compliance  
Senior Management

## KEY TOPICS

NASD By-Laws

## ACTION REQUIRED

### Mail Vote

NASD Solicits Member Vote on Amendments to NASD By-Laws to Reconfigure NASD Board; **Last Voting Date: May 6, 2004**

### Executive Summary

NASD invites members to vote to approve amendments to the NASD By-Laws that will: eliminate two seats on the NASD Board of Governors (NASD Board) that are currently reserved for representatives of the American Stock Exchange (Amex); eliminate the required inclusion of an Amex-affiliated Governor on the Executive Committee of the NASD Board; eliminate references to Amex from the definitional and conflict-of-interest provisions of the NASD By-Laws; and make certain clarifying amendments. The last voting date is May 6, 2004. The text of the proposed amendments follows this Notice.

### Questions/Further Information

Questions concerning this *Notice* may be directed to T. Grant Callery, Executive Vice President and General Counsel, at (202) 728-8285; or Anne H. Wright, Associate Vice President and Associate General Counsel, at (202) 728-8815.

### Background

On February 26, 2004, the NASD Board approved an agreement under which NASD will sell its interest in Amex to the exchange's membership. The agreement was subsequently approved by the Amex Board of Governors and the Amex membership. The disposition of Amex represents an important step in achieving NASD's strategic goal of eliminating ownership interests in markets in order to focus on its core mission as a private-sector regulator.

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The proposed amendments will reverse a number of By-Law provisions that were added in 1998, when NASD acquired Amex. The proposed changes are discussed briefly below, and the text of the proposed changes is attached as Exhibit A. In Exhibit A, proposed new language is underlined; proposed deletions are shown as struck-through text. The amendments will become effective upon the closing of the transaction.

## Amendments to the NASD By-Laws

### Article I (Definitions)

The amendments will eliminate references to both Amex and The Nasdaq Stock Market, Inc. (NASDAQ) from the definitions of "Industry Director," "Industry Governor," "Non-Industry Director," "Non-Industry Governor," "Public Director," and "Public Governor."

Instead of the current references to NASDAQ and Amex, these definitions will refer to "a market regulated by NASD." For example, the definition of "Industry Governor" currently includes persons with a consulting or employment relationship with NASD, NASD Regulation, NASD Dispute Resolution, NASDAQ, or Amex. Under the proposed amendments, the "Industry Governor" definition will include persons with a consulting or employment relationship with "any market regulated by NASD," a term that embraces a market NASD regulates by virtue of an ownership interest (e.g., NASDAQ), and any market with which NASD has entered a contract to provide regulatory services.

In addition, clarifying amendments are proposed for the definitions of "Non-Industry Director" and "Non-Industry Governor," which currently include an officer or employee of an issuer of securities "traded in the over-the-counter market." Since both listed and unlisted securities may be traded in the over-the-counter market, this provision has been amended to clarify that the terms "Non-Industry Director" and "Non-Industry Governor" include an officer or employee of "an issuer of unlisted securities that are traded in the over-the-counter market."

Finally, the definitions of "Floor Governor," "Amex," and "Amex Board" have been eliminated.

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### **Article VII (Board of Governors)**

The proposed amendments will eliminate two seats on the NASD Board that have been reserved for the Chief Executive Officer of Amex and an Amex Floor Governor. The elimination of these seats will permit NASD to reduce the overall size of the Board. The current authorized size of the Board is between 17 and 27 members. With the elimination of the Amex seats, the authorized size of the Board will be reduced to between 15 and 25.

Under Delaware law, the NASD Board determines how many of the authorized seats should be filled. Because smaller boards tend to function more efficiently than larger boards, the NASD Board has repeatedly stated a preference against filling all authorized seats if the other compositional requirements set forth in the By-Laws can be met without the maximum permissible number of Governors.

The proposed amendments will eliminate from Section 5 of Article VII the provision that sets the maximum permissible term of the Amex Floor Governor.

### **Article IX (Committees)**

Article IX establishes the NASD Executive Committee, which is authorized to act on behalf of the NASD Board between meetings of the NASD Board. Currently, the committee must include six to nine members, at least one of whom must be an Amex representative, but at least two of whom may not be members of the Boards of either NASD Regulation or the Amex.

The proposed amendments will reduce the authorized size range of the committee by one, eliminate the requirement that an Amex representative be included on the committee, and eliminate the requirement that at least two members of the committee be members of neither the Amex nor NASD Regulation Boards.

### **Article XV (Limitation of Powers)**

Subsection 4(b) of Article XV governs participation in contracts or transactions in which a Governor has a conflict of interest. However, the subsection currently does not apply to contracts or transactions between NASD, and NASD Regulation, NASDAQ, NASD Dispute Resolution, or Amex. The proposed amendments will eliminate Amex from this exemptive provision.

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**BY-LAWS OF THE NATIONAL ASSOCIATION OF  
SECURITIES DEALERS, INC.**

**ARTICLE I**

**DEFINITIONS**

When used in these By-Laws, unless the context otherwise requires, the term:

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(n) “Industry Director” means a Director of the NASD Regulation Board or NASD Dispute Resolution Board (excluding the Presidents) who: (1) is or has served in the prior three years as an officer, director, or employee of a broker or dealer, excluding an outside director or a director not engaged in the day-to-day management of a broker or dealer; (2) is an officer, director (excluding an outside director), or employee of an entity that owns more than ten percent of the equity of a broker or dealer, and the broker or dealer accounts for more than five percent of the gross revenues received by the consolidated entity; (3) owns more than five percent of the equity securities of any broker or dealer, whose investments in brokers or dealers exceed ten percent of his or her net worth, or whose ownership interest otherwise permits him or her to be engaged in the day-to-day management of a broker or dealer; (4) provides professional services to brokers or dealers, and such services constitute 20 percent or more of the professional revenues received by the Director or 20 percent or more of the gross revenues received by the Director’s firm or partnership; (5) provides professional services to a director, officer, or employee of a broker, dealer, or corporation that owns 50 percent or more of the voting stock of a broker or dealer, and such services relate to the director’s, officer’s, or employee’s professional capacity and constitute 20 percent or more of the professional revenues received by the Director or 20 percent or more of the gross revenues received by the Director’s firm or partnership; or (6) has a consulting or employment relationship with or provides professional services to the NASD, NASD Regulation, NASD Dispute Resolution, ~~Nasdaq, or Amex (and any predecessor)~~ a market regulated by NASD, - or has had any such relationship or provided any such services at any time within the prior three years;

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(o) "Industry Governor" or "Industry committee member" means a Governor (excluding the Chief Executive Officer of the NASD and the President of NASD Regulation) or committee member who: (1) is or has served in the prior three years as an officer, director or employee of a broker or dealer, excluding an outside director or a director not engaged in the day-to-day management of a broker or dealer; (2) is an officer, director (excluding an outside director), or employee of an entity that owns more than ten percent of the equity of a broker or dealer, and the broker or dealer accounts for more than five percent of the gross revenues received by the consolidated entity; (3) owns more than five percent of the equity securities of any broker or dealer, whose investments in brokers or dealers exceed ten percent of his or her net worth, or whose ownership interest otherwise permits him or her to be engaged in the day-to-day management of a broker or dealer; (4) provides professional services to brokers or dealers, and such services constitute 20 percent or more of the professional revenues received by the Governor or committee member or 20 percent or more of the gross revenues received by the Governor's or committee member's firm or partnership; (5) provides professional services to a director, officer, or employee of a broker, dealer, or corporation that owns 50 percent or more of the voting stock of a broker or dealer, and such services relate to the director's, officer's, or employee's professional capacity and constitute 20 percent or more of the professional revenues received by the Governor or committee member or 20 percent or more of the gross revenues received by the Governor's or committee member's firm or partnership; or (6) has a consulting or employment relationship with or provides professional services to the NASD, NASD Regulation, NASD Dispute Resolution, ~~Nasdaq or Amex (and any predecessor)~~, or a market regulated by NASD, or has had any such relationship or provided any such services at any time within the prior three years;

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(bb) "Non-Industry Director" means a Director of the NASD Regulation Board or NASD Dispute Resolution Board (excluding the Presidents of NASD Regulation and NASD Dispute Resolution) who is: (1) a Public Director; (2) an officer or employee of an issuer of securities listed on ~~Nasdaq or Amex~~, or a market regulated by NASD; (3) an officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market; or (34) any other individual who would not be an Industry Director;

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(cc) “Non-Industry Governor” or “Non-Industry committee member” means a Governor (excluding the Chief Executive Officer and any other officer of the NASD, the President of NASD Regulation), ~~any Floor Governor, and the Chief Executive Officer of Amex~~ or committee member who is: (1) a Public Governor or committee member; (2) an officer or employee of an issuer of securities listed on ~~Nasdaq or Amex~~, or a market regulated by NASD; (3) an officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market; or (34) any other individual who would not be an Industry Governor or committee member;

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(ee) “Public Director” means a Director of the NASD Regulation Board or NASD Dispute Resolution Board who has no material business relationship with a broker or dealer or the NASD, NASD Regulation, NASD Dispute Resolution, or ~~Nasdaq~~ a market regulated by NASD;

(ff) “Public Governor” or “Public committee member” means a Governor or committee member who has no material business relationship with a broker or dealer or the NASD, NASD Regulation, NASD Dispute Resolution, or ~~Nasdaq~~ a market regulated by NASD;

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~~(ii) “Floor Governor” or “Amex Floor Governor” means a Floor Governor of Amex elected pursuant to Article II, Section .01(a) of the Amex By Laws;~~

~~(jj) “Amex” means American Stock Exchange LLC; and~~

~~(kk) “Amex Board” means the Board of Governors of Amex.~~

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## ARTICLE VII

### BOARD OF GOVERNORS

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#### Composition and Qualifications of the Board

**Sec. 4.** (a) The Board shall consist of no fewer than 175 nor more than 275 Governors, comprising (i) the Chief Executive Officer of the NASD, ii) if the Board of Governors determines, from time to time, in its sole discretion, that the appointment of a second officer of the NASD to the Board of Governors is advisable, a second officer of the NASD, (iii) the President of NASD Regulation, (iv) the Chair of the National Adjudicatory Council, ~~(v) the Chief Executive Officer and one Floor Governor of Amex,~~ and (vi) no fewer than 12 and no more than 22 Governors elected by the members of the NASD. The Governors elected by the members of the NASD shall include a representative of an issuer of investment company shares or an affiliate of such an issuer, a representative of an insurance company, a representative of a national retail firm, a representative of a regional retail or independent financial planning member firm, a representative of a firm that provides clearing services to other NASD members, and a representative of an NASD member having not more than 150 registered persons. The number of Non-Industry Governors shall exceed the number of Industry Governors. If the number of Industry and Non-Industry Governors is ~~15 to 17~~ 13-15, the Board shall include at least four Public Governors. If the number of Industry and Non-Industry Governors is ~~18 to 19~~ 16-17, the Board shall include at least five Public Governors. If the number of Industry and Non-Industry Governors is ~~20 to 25~~ 18-23, the Board shall include at least six Public Governors.

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## Term of Office of Governors

**Sec. 5.** (a) The Chief Executive Officer and, if appointed, the second officer of the NASD, and the President of NASD Regulation, ~~and the Chief Executive Officer of Amex~~ shall serve as Governors until a successor is elected, or until death, resignation, or removal (or, in addition, in the case of a second officer of the NASD, until the Board of Governors, in its sole discretion, determines that such appointment is no longer advisable).

(b) The Chair of the National Adjudicatory Council shall serve as a Governor for a term of one year, or until a successor is duly elected and qualified, or until death, resignation, disqualification, or removal. A Chair of the National Adjudicatory Council may not serve more than two consecutive one-year terms as a Governor, unless a Chair of the National Adjudicatory Council is appointed to fill a term of less than one year for such office. In such case, the Chair of the National Adjudicatory Council may serve an initial term as a Governor and up to two consecutive one-year terms as a Governor following the expiration of such initial term. After serving as a Chair of the National Adjudicatory Council, an individual may serve as a Governor elected by the members of the NASD.

~~(c) The Amex Floor Governor shall serve as a Governor for a term of two years, or until a successor is duly elected and qualified, or until death, resignation, disqualification, or removal. An Amex Floor Governor may not serve more than three consecutive two-year terms as a Governor, unless such Amex Floor Governor is appointed to fill a term of less than one year for such office. In such case, the Amex Floor Governor may serve that initial term as a Governor and up to three consecutive two-year terms as a Governor following the expiration of the initial term.~~

(c~~d~~) The Governors elected by the members of the NASD shall be divided into three classes and hold office for a term of no more than three years, such term to be fixed by the Board at the time of the nomination or certification of each such Governor, or until a successor is duly elected and qualified, or until death, resignation, disqualification, or removal. A Governor elected by the members of the NASD may not serve more than two consecutive terms. If a Governor is elected by the Board to fill a term of less than one year, the Governor may serve up to two

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consecutive terms following the expiration of the Governor's initial term. The term of office of Governors of the first class shall expire at the January 1999 Board meeting, of the second class one year thereafter, and of the third class two years thereafter. At each annual election, commencing January 1999, Governors shall be elected for a term of three years to replace those whose terms expire.

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## ARTICLE IX COMMITTEES

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### Executive Committee

**Sec. 4.** (a) The Board may appoint an Executive Committee, which shall, to the fullest extent permitted by the General Corporation Law of the State of Delaware and other applicable law, have and be permitted to exercise all the powers and authority of the Board in the management of the business and affairs of the NASD between meetings of the Board, and which may authorize the seal of the NASD to be affixed to all papers that may require it.

(b) The Executive Committee shall consist of no fewer than ~~six~~ five and no more than ~~nine~~ eight Governors. The Executive Committee shall include the Chief Executive Officer of the NASD, and at least one Director of NASD Regulation, ~~at least one Governor of Amex, and at least two Governors who are not members of either the NASD Regulation Board, or the Amex Board.~~ The Executive Committee shall have a percentage of Non-Industry committee members at least as great as the percentage of Non-Industry Governors on the whole Board and a percentage of Public committee members at least as great as the percentage of Public Governors on the whole Board.

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(c) An Executive Committee member shall hold office for a term of one year.

(d) At all meetings of the Executive Committee, a quorum for the transaction of business shall consist of a majority of the Executive Committee, including not less than 50 percent of the Non-Industry committee members. In the absence of a quorum, a majority of the committee members present may adjourn the meeting until a quorum is present.

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## ARTICLE XV

### LIMITATION OF POWERS

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#### Conflicts of Interest

**Sec. 4.** (a) A Governor or a member of a committee shall not directly or indirectly participate in any adjudication of the interests of any party if such Governor or committee member has a conflict of interest or bias, or if circumstances otherwise exist where his or her fairness might reasonably be questioned. In any such case, the Governor or committee member shall recuse himself or herself or shall be disqualified in accordance with the Rules of the Association.

(b) No contract or transaction between the NASD and one or more of its Governors or officers, or between the NASD and any other corporation, partnership, association, or other organization in which one or more of its Governors or officers are directors or officers, or have a financial interest, shall be void or voidable solely for this reason if: (i) the material facts pertaining to such Governor's or officer's relationship or interest and the contract or transaction are disclosed or are known to the Board or the committee, and the Board or committee in good faith authorizes the contract or transaction by the affirmative vote of a majority of the disinterested

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Governors, even though the disinterested governors be less than a quorum; or (ii) the material facts are disclosed or become known to the Board or committee after the contract or transaction is entered into, and the Board or committee in good faith ratifies the contract or transaction by the affirmative vote of a majority of the disinterested Governors even though the disinterested governors be less than a quorum. Only disinterested Governors may be counted in determining the presence of a quorum at the portion of a meeting of the Board or of a committee that authorizes the contract or transaction. This subsection shall not apply to any contract or transaction between the NASD and NASD Regulation, Nasdaq, or NASD Dispute Resolution, ~~or Amex.~~

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