

September 2, 2004

Katherine A. England  
Assistant Director  
Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-1001

Re: File No. **SR-NASD-2004-110, Amendment No. 3** – Amendments to NASD,  
NASD Regulation, and NASD Dispute Resolution By-Laws Relating to  
Divestiture of the American Stock Exchange

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the Amendment No. 3 to the above-numbered rule filing. Amendment No. 3 modifies Exhibit 1 to include an expanded explanation of the purpose of the proposed rule changes. In addition, certain technical corrections have been made. The enclosed supersedes the version of the rule filing that was filed with the Commission on August 25, 2004. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Anne H. Wright, Associate Vice President and Associate General Counsel, NASD Office of General Counsel, at (202) 728-8815; e-mail [anne.wright@nasd.com](mailto:anne.wright@nasd.com). The fax number of the Office of General Counsel is (202) 728-8894.

Very truly yours,

Barbara Z. Sweeney  
Senior Vice President  
and Corporate Secretary

Enclosures

cc: Heather Seidel, Esq.  
Brian Trackman, Esq.

File No. **SR-NASD-2004-110**  
Consists of 43 Pages  
September 2, 2004  
Amendment No. 3

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C.

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Form 19b-4

Proposed Rule Change

by

**NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.**

Pursuant to Rule 19b-4 under the  
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to: amend the NASD By-Laws to reflect NASD’s divestiture of its ownership interest in the American Stock Exchange (“Amex”); make conforming changes to the By-laws of NASD Regulation, Inc. (“NASD Regulation”) and NASD Dispute Resolution, Inc. (“Dispute Resolution”); terminate certain undertakings into which NASD entered when it acquired Amex in 1998, and to make certain other clarifying amendments. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

**PROPOSED REVISIONS TO BY-LAWS OF  
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.**

**ARTICLE I**

**DEFINITIONS**

\* \* \* \* \*

(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 for which NASD provides regulation, or has had any such relationship or provided any such services at any time within the prior three years;

(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; [(6) is a Floor Governor,] or ([7]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 for which NASD provides regulation, or has had any such relationship or provided any such services at any time within the prior three years;

\* \* \* \* \*

(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 for which NASD provides regulation; (3) an officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market; or ([3]4) any other individual who would not be an Industry Director;

(cc) "Non-Industry Governor" or "Non-Industry committee member" means a Governor (excluding the Chief Executive Officer and any other officer of the NASD, the President of NASD Regulation)[, 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 for which NASD provides regulation; (3) an officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market; or ([3]4) any other individual who would not be an Industry Governor or committee member;

\* \* \* \* \*

(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 for which NASD provides regulation;

(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 for which NASD provides regulation;

\* \* \* \* \*

[(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.]

\* \* \* \* \*

**ARTICLE VII**

**BOARD OF GOVERNORS**

\* \* \* \* \*

**Composition and Qualifications of the Board**

**Sec. 4.** (a) The Board shall consist of no fewer than [17] 15 nor more than [27] 25 Governors, comprising (i) the Chief Executive Officer of the NASD, (ii) if the Board of Governors determines, from time to time, in its sole discretion, that the appointment of a second officer of the NASD to the Board of Governors is advisable, a second officer of the NASD, (iii) the President of NASD Regulation, (iv) the Chair of the National Adjudicatory Council, [(v) the Chief Executive Officer and one Floor Governor of Amex,] and [(vi)] (v) no fewer than 12 and no more than 22 Governors elected by the members of the NASD. The Governors elected by the members of the NASD shall include a representative of an issuer of investment company shares or an affiliate of such an issuer, a representative of an insurance company, a representative of a national retail firm, a representative of a regional retail or independent financial planning member firm, a representative of a firm that provides clearing services to other NASD members, and a representative of an NASD member having not more than 150 registered persons. The number of Non-Industry Governors shall exceed the number of Industry Governors. If the number of Industry and Non-Industry Governors is [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 [20-25] 18-23, the Board shall include at least six Public Governors.

\* \* \* \* \*

**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 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.

\* \* \* \* \*

## **ARTICLE IX**

### **COMMITTEES**

\* \* \* \* \*

#### **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.

(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.

\* \* \* \* \*

## **ARTICLE XV**

### **LIMITATION OF POWERS**

\* \* \* \* \*

#### **Conflicts of Interest**

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

(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 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].

\* \* \* \* \*

**PROPOSED REVISIONS TO BY-LAWS OF  
NASD REGULATION, INC.**

**ARTICLE I**

**DEFINITIONS**

\* \* \* \* \*

(q) "Industry Director" or "Industry member" means a Director (excluding the President of NASD Regulation and the Chief Executive Officer of NASD) or a National Adjudicatory Council 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 Director or member or 20 percent or more of the gross revenues received by the Director's or 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 Director or member or 20 percent or more of the gross revenues received by the Director's or member's firm or partnership; or (6) has a consulting or employment relationship with or provides professional services to the NASD, NASD Regulation, [Nasdaq,] NASD Dispute Resolution, or [Amex (and any Predecessor),] a market for which NASD provides regulation, or has had any such relationship or provided any such services at any time within the prior three years;

\* \* \* \* \*

(y) "Non-Industry Director" or "Non-Industry member" means a Director (excluding the

President of NASD Regulation and the Chief Executive Officer of NASD) or a National Adjudicatory Council or committee member who is (1) a Public Director or Public member; (2) an officer or employee of an issuer of securities listed on [Nasdaq or Amex,] a market for which NASD provides regulation; (3) an officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market; or [(3)](4) any other individual who would not be an Industry Director or Industry member;

\* \* \* \* \*

(aa) "Public Director" or "Public member" means a Director or National Adjudicatory Council or committee member who has no material business relationship with a broker or dealer or the NASD, NASD Regulation, or [Nasdaq;] a market for which NASD provides regulation;

\* \* \* \* \*

[(dd) "Floor Governor" or "Amex Floor Governor" means a Floor Governor of Amex elected pursuant to Article I, Section 01(a) of the Amex By-Laws;

(ee) "Nasdaq-Amex" means Nasdaq-Amex Market Group, Inc.;

(ff) "Amex" means American Stock Exchange LLC;

(gg) "Amex Board" means the Board of Governors of Amex;]

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## **ARTICLE IV**

### **BOARD OF DIRECTORS**

\* \* \* \* \*

#### **Sec. 4.14 (a) Conflicts of Interest; Contracts and Transactions Involving Directors**

**Sec. 4.14 (a)** A Director or a National Adjudicatory Council or committee member shall not directly or indirectly participate in any adjudication of the interests of any party if that Director or National Adjudicatory Council 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 Director or National Adjudicatory Council 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 NASD Regulation and one or more of its Directors or officers, or between NASD Regulation and any other corporation, partnership,

association, or other organization in which one or more of its Directors 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 Director'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 Directors; (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 Directors; or (iii) the material facts pertaining to the Director's or officer's relationship or interest and the contract or transaction are disclosed or are known to the stockholder entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the stockholder. Only disinterested Directors 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 a contract or transaction between NASD Regulation and[:] the NASD, NASD Dispute Resolution, or Nasdaq[, Nasdaq-Amex, or Amex].

\* \* \* \* \*

**PROPOSED AMENDMENTS TO BY-LAWS OF  
NASD DISPUTE RESOLUTION, INC.**

**ARTICLE I**

**DEFINITIONS**

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

(a) “Act” means the Securities Exchange Act of 1934, as amended;

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

~~(b)~~ [(c)] “Board” means the Board of Directors of NASD Dispute Resolution;

~~(c)~~ [(d)] “broker” shall have the same meaning as in Section 3(a)(4) of the Act;

~~(d)~~ [(e)] “Commission” means the Securities and Exchange Commission;

~~(e)~~ [(f)] “day” means calendar day;

~~(f)~~ [(g)] “dealer” shall have the same meaning as in Section 3(a)(5) of the Act;

~~(g)~~ [(h)] “Delaware law” means the General Corporation Law of the State of Delaware;

~~(h)~~ [(i)] “Delegation Plan” means the “Plan of Allocation and Delegation of Functions by NASD to Subsidiaries” as approved by the Commission, and as amended from time to time;

~~(i)~~ [(j)] “Director” means a member of the Board, excluding the Chief Executive Officer of the NASD;

~~(j)~~ [(k)] “Executive Representative” means the executive representative of an NASD member appointed pursuant to Article IV, Section 3 of the NASD By-Laws;

~~(k)~~ [(l)] “Industry Director” or “Industry member” means a Director (excluding the President) or a 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 Director or member or 20 percent or more of the gross revenues received by the Director's or 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 Director or member or 20 percent or more of the gross revenues received by the Director's or member's firm or partnership; or (6) has a consulting or employment relationship with or provides professional services to the NASD, NASD Regulation, [Nasdaq,] NASD Dispute Resolution, or [Amex (and any predecessor),] a market for which NASD provides regulation, or has had any such relationship or provided any such services at any time within the prior three years;

(l) [(m)] "NASD" means the National Association of Securities Dealers, Inc.;

(m) [(n)] "NASD Board" means the NASD Board of Governors;

(n) [(o)] "NASD Dispute Resolution" means NASD Dispute Resolution, Inc.;

(o) [(p)] "NASD member" means any broker or dealer admitted to membership in the NASD;

(p) [(q)] "NASD Regulation" means NASD Regulation, Inc.;

(q) [(r)] "Nasdaq" means The Nasdaq Stock Market, Inc.;

[(s)] "Nasdaq-Amex" means Nasdaq-Amex Market Group, Inc.;

(r) [(t)] "National Nominating Committee" means the National Nominating Committee appointed pursuant to Article VII, Section 9 of the NASD By-Laws;

(s) [(u)] "Non-Industry Director" or "Non-Industry member" means a Director (excluding the President) or committee member who is (1) a Public Director or Public member; (2) an officer or employee of an issuer of securities listed on [Nasdaq or Amex, or] a market for which NASD provides regulation; (3) an officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market; or [(3)] (4) any other individual who would not be an Industry Director or Industry member;

(t) [(v)] "person associated with a member" or "associated person of a member" means: (1) a natural person registered under the Rules of the Association; or (2) a sole

proprietor, partner, officer, director, or branch manager of a member, or a natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with the NASD under these By-Laws or the Rules of the Association;

(u) [(w)] “Public Director” or “Public member” means a Director or committee member who has no material business relationship with a broker or dealer or the NASD, NASD Regulation, [Nasdaq,] a market for which NASD provides regulation, or NASD Dispute Resolution;

\* \* \* \* \*

(v) [(x)] “Rules of the Association” or “Rules” means the numbered rules set forth in the NASD Manual beginning with the Rule 0100 Series, as adopted by the NASD Board pursuant to the NASD By-Laws, as hereafter amended or supplemented.

#### **ARTICLE IV**

#### **BOARD OF DIRECTORS**

\* \* \* \* \*

#### **Conflicts of Interest; Contracts and Transactions Involving Directors**

**Sec. 4.14** (a) A Director or a committee member shall not directly or indirectly participate in any determinations regarding the interests of any party if that Director 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 Director 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 NASD Dispute Resolution and one or more of its Directors or officers, or between NASD Dispute Resolution and any other corporation, partnership, association, or other organization in which one or more of its Directors 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 Director'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 Directors; (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 Directors; or (iii) the material facts

pertaining to the Director's or officer's relationship or interest and the contract or transaction are disclosed or are known to the stockholder entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the stockholder. Only disinterested Directors 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 a contract or transaction between NASD Dispute Resolution and the NASD, NASD Regulation, or Nasdaq[, Nasdaq-Amex, or Amex].

\* \* \* \* \*

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) On February 26, 2004, the NASD Board of Governors approved an agreement under which NASD will transfer its interest in Amex to the exchange's membership, and authorized NASD staff to submit related amendments to NASD's corporate documents for the approval of the NASD membership and the SEC. The proposed amendments to the NASD By-Laws were published for member vote on April 6, 2004 in NASD Special Notice to Members 04-27. The last day for member vote was May 6, 2004. 2,094 NASD members voted to approve the revised NASD By-Laws, and 72 voted against.<sup>1</sup>

Pending Commission approval, the proposed rule change is intended to become effective upon closing of the Amex transaction, and NASD will announce the effective date in a Notice to Members.

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<sup>1</sup> NASD, as the sole stockholder of NASD Regulation and Dispute Resolution, is authorized to amend the By-laws of those entities. Because the approval of the NASD membership is not required to effect the proposed conforming changes to the By-laws of NASD Regulation and Dispute Resolution, those changes were not addressed in Special Notice to Members 04-27. NASD lacks authority unilaterally to make conforming changes to the By-laws of The Nasdaq Stock Market, Inc.; separate action by the Nasdaq Board of Directors will be necessary to effect these changes.

(b) Questions regarding this rule filing may be directed to Anne H. Wright, Associate Vice President and Associate General Counsel, NASD Office of General Counsel, at (202) 728-8815.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

The proposed rule change will reverse a number of changes that NASD made to the By-laws of NASD, NASD Regulation, and Dispute Resolution in 1998, when NASD acquired Amex. In addition, NASD proposes to withdraw certain representations it made in 1998 regarding its relationship with Amex following the Amex acquisition. Finally, NASD proposes to make certain other clarifying changes.

**Proposed By-Law Revisions**

The proposed By-law changes are discussed briefly below. Where noted, parallel changes will be made to the By-laws of NASD Regulation and Dispute Resolution.

***Article I (Definitions)***

The amendments will eliminate references to both Amex and Nasdaq from the definitions of “Industry Director,” “Industry Governor,” “Non-Industry Director,” and “Non-Industry Governor,” “Public Director,” and “Public Governor.” The current references to Nasdaq and Amex will be replaced with references to “a market for which NASD provides regulation.” 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 “a market



for which NASD provides regulation,” a term that embraces both markets with which NASD has entered a contract to provide regulatory services, and those in which NASD has an ownership interest. Because NASD has entered into a regulatory services agreement with Amex, and continues both to maintain an ownership interest in and to provide regulatory services to Nasdaq, the amended definition of “Industry Governor” will continue to encompass individuals who have a consulting or employment relationship with Amex or Nasdaq. NASD believes that, given the difficulty and expense involved in amending the NASD By-Laws when regulatory clients are added or deleted, substituting “a market for which NASD provides regulation” is preferable to identifying such clients by name in the By-Laws.

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.” Historically, NASD has interpreted this provision as applying only to officers and employees of unlisted securities traded in the over-the-counter market: NASD has never applied the provision to include officers and employees of listed securities that were traded off-exchange. However, since both listed and unlisted securities may be traded in the over-the-counter market, Article I, Sections (bb) and (cc) have been amended to reflect NASD’s historical interpretation of the definitions. The proposed amendments make no substantive change to the definitions; rather, the amendments simply seek to clarify that (renumbered) Subsections 3 of the “Non-Industry Director” and “Non-Industry Governor” definitions include an officer or employee of only an issuer of unlisted securities that are traded exclusively in the over-the-counter market.

Finally, the definitions of and references to “Floor Governor,” “Amex,” and “Amex Board” have been eliminated.

Parallel changes are proposed for the definitional provisions of the NASD Regulation and Dispute Resolution By-Laws.

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

The proposed amendments will eliminate two seats on the NASD Board that have been reserved for the Chief Executive 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.

The proposed amendments will leave unchanged the existing requirement that the NASD Board include a minimum of four to six Public Governors. However, the numeric thresholds for these minimums will be adjusted downward to reflect the smaller overall Board size. For example, the By-Laws currently require a minimum of four Public Governors when the combined number of Industry and Non-Industry Governors is 15 to 17; under the proposed amendments, a minimum of four Public Governors will be required when the combined number of Industry and Non-Industry Governors is 13 to 15.

No change is proposed to the existing requirement that the number of Non-Industry Governors exceed the number of Industry Governors.

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, NASD has repeatedly stated a preference to avoid filling all authorized seats if the

compositional requirements set forth in the By-Laws can be met without the maximum permissible number of Governors.

In addition, 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, and eliminate the requirement that an Amex representative be included on the committee. The proposed amendments also will eliminate the current requirement that at least two members of the committee be members of neither the Amex nor NASD Regulation boards. NASD notes that requiring at least two NASD-only members of the Executive Committee appears to have responded to concerns that arose when there were multiple subsidiaries (at various times Nasdaq, Amex, and/or NASD Regulation) that were entitled to representation on both the NASD Board and the Executive Committee.<sup>2</sup>

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<sup>2</sup> In 1997, NASD made extensive modifications to its corporate documents in response to the Report of the Select Committee on Structure and Governance to the NASD Board of Governors (Select Committee Report) and the Commission's 1996 Report Pursuant to Section 21(a) of the Act (Section 21(a) Report). Among other things, Article IX, Section 4 was amended to authorize the appointment of the Executive Committee. The 1997 amendments included requirements that: (i) Nasdaq and NASD Regulation be represented on the committee; and (ii) at least two of the committee members not be affiliated with those subsidiaries. See Exchange Act Release No. 39326 (Nov. 14, 1997), 62 F.R. 62385 (November 21, 1997). Following the acquisition of Amex in 1998, Amex was added to the entities entitled to representation on the Committee. See Exchange Act Release No. 40622 (Oct. 30, 1998), 63 F.R. 59819 (November 5, 1998). Nasdaq's right to

NASD notes that avoiding possible domination of NASD affairs by market interests, and a corresponding diminution of NASD regulatory responsibilities, has represented a primary consideration in NASD corporate governance since the Select Committee Report was issued in 1995. With the elimination of “status” seats reserved for Nasdaq and Amex representatives, however, NASD believes concerns that these markets could dominate NASD decision-making also are eliminated.

The elimination of mandatory market representation on the Executive Committee will leave NASD Regulation as the sole remaining subsidiary entitled to be represented on the committee. Under the proposed rule change, NASD Regulation will continue to be entitled to at least one representative on the Executive Committee. However, because NASD believes the possibility that regulatory interests could improperly dominate NASD decision making would not raise the same concerns as the possibility of market-interest domination, the proposed amendments do not specify any minimum number of NASD-only Governors who must be included on the Executive Committee. NASD believes that the proposed changes to the Executive Committee composition are consistent with the Select Committee Report and the Section 21(a) Report.

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

Subsection 4(b) of Article XV governs participation in transactions in which Governors have a conflict of interest. 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. As a

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representation on the committee was terminated in 2001. See Exchange Act Release No. 44280 (May 8, 2001), 66 F.R. 26892 (May 15, 2001).

result of this change, an Amex-affiliated Governor could no longer be counted as disinterested for purposes of determining the presence of a quorum at the portion of a meeting of the Board that authorizes a contract or transaction with Amex.

Parallel changes are proposed for the conflict-of-interest provisions of the NASD Regulation and Dispute Resolution By-laws.

### **1998 Undertakings Regarding NASD-Amex Relationship**

In 1998, NASD articulated certain principles that would guide the organization in fulfilling its responsibilities as parent company of Amex with ultimate responsibility for Amex's compliance with its statutory responsibilities as a self-regulatory organization ("SRO").<sup>3</sup> Upon completion of NASD's divestiture of its ownership interest in Amex, these principles will no longer be applicable. Instead, the NASD-Amex relationship will be governed by the regulatory services agreement into which the organizations have entered. Because the Commission approved the 1998 undertakings as NASD rules,<sup>4</sup> NASD now seeks the Commission's approval of the withdrawal of the undertakings.

#### **(b) Statutory Basis**

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(4) of the Act which requires, among other things, that NASD's rules assure a

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<sup>3</sup> Among other things, NASD represented that it would exercise its powers and its managerial influence to ensure that Amex fulfilled its self-regulatory obligations by directing Amex to take action necessary to effectuate its purposes and functions as a national securities exchange operating pursuant to the Act, and ensuring that Amex had and appropriately allocated such financial, technological, technical, and personnel resources as may be necessary or appropriate to meet its obligations under the Act. NASD also committed to refraining from taking any action with respect to Amex that would impede efforts by Amex to carry out its SRO obligations. See File No. SR-NASD-98-67 – Policies Regarding Authority Over American Stock Exchange LLC and Composition of Board of Governors of American Stock Exchange LLC (Sept. 11, 1998).

fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of NASD, broker or dealer. NASD also believes the proposed rule change is consistent with Section 15A(b)(6) of the Act, which requires that NASD's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and protect investors and the public interest.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

6. Extension of Time Period for Commission Action

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

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<sup>4</sup> See Exchange Act Release No. 40622 (Oct. 30, 1998), 63 F.R. 59819 (November 5, 1998) (describing NASD's undertakings regarding Amex).

1. Completed notice of proposed rule change for publication in the Federal Register.
2. NASD Special Notice to Members 04-27 (April 6, 2004).
3. Certificate and Report of Voting issued by Corporate Election Services (May 11, 2004).
4. Red-line comparison of Amendment No. 3 and the original rule filing.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD, INC.

BY: \_\_\_\_\_  
Barbara Z. Sweeney,  
Senior Vice President and Corporate Secretary

Date: September 2, 2004

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34- ; File No. SR-NASD-2004-110)  
[date]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Divestiture of American Stock Exchange

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on July 15, 2004 the National Association of Securities Dealers, Inc. (“NASD”), filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD is proposing to amend provisions of its by-laws to reflect NASD’s divestiture of its ownership interest in the American Stock Exchange (“Amex”). NASD is also proposing to make parallel changes to the definitional and conflict-of-interest provisions of the by-laws of NASD Regulation, Inc. (“NASD Regulation”) and NASD Dispute Resolution, Inc. (“Dispute Resolution”), to terminate certain undertakings NASD assumed when it acquired Amex in 1998, and to make certain other clarifying amendments. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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

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



\* \* \* \* \*

**PROPOSED REVISIONS TO BY-LAWS OF  
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.**

**ARTICLE I**

**DEFINITIONS**

\* \* \* \* \*

(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 for which NASD provides regulation, or has had any such relationship or provided any such services at any time within the prior three years;

(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; [(6) is a Floor Governor,] or ([7]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 for which NASD provides regulation, or has had any such relationship or provided any such services at any time within the prior three years;

\* \* \* \* \*

(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 for which NASD provides regulation; (3) an officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market; or ([3]4) any other individual who would not be an Industry Director;

(cc) "Non-Industry Governor" or "Non-Industry committee member" means a Governor (excluding the Chief Executive Officer and any other officer of the NASD, the President of NASD Regulation)[, 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 for which NASD provides regulation; (3) an officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market; or ([3]4) any other individual who would not be an Industry Governor or committee member;

\* \* \* \* \*

(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 for which NASD provides regulation;

(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 for which NASD provides regulation;

\* \* \* \* \*

[(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**

\* \* \* \* \*

**Composition and Qualifications of the Board**

**Sec. 4.** (a) The Board shall consist of no fewer than [17] 15 nor more than [27] 25 Governors, comprising (i) the Chief Executive Officer of the NASD, (ii) if the Board of Governors determines, from time to time, in its sole discretion, that the appointment of a second officer of the NASD to the Board of Governors is advisable, a second officer of the NASD, (iii) the President of NASD Regulation, (iv) the Chair of the National Adjudicatory Council, [(v) the Chief Executive Officer and one Floor Governor of Amex,] and [(vi)] (v) no fewer than 12 and no more than 22 Governors elected by the members of the NASD. The Governors elected by the members of the NASD shall include a representative of an issuer of investment company shares or an affiliate of such an issuer, a representative of an insurance company, a representative of a national retail firm, a representative of a regional retail or independent financial planning member firm, a representative of a firm that provides clearing services to other NASD members, and a representative of an NASD member having not more than 150 registered persons. The number of Non-Industry Governors shall exceed the number of Industry Governors. If the number of Industry and Non-Industry Governors is [15 to 17] 13 to 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 [20-25] 18-23, the Board shall include at least six Public Governors.

\* \* \* \* \*

**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 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**

\* \* \* \* \*

**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.

(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.

\* \* \* \* \*

**ARTICLE XV**

**LIMITATION OF POWERS**

\* \* \* \* \*

**Conflicts of Interest**

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

(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 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].

\* \* \* \* \*

**PROPOSED REVISIONS TO BY-LAWS OF  
NASD REGULATION, INC.**

**ARTICLE I**

**DEFINITIONS**

\* \* \* \* \*

(q) "Industry Director" or "Industry member" means a Director (excluding the President of NASD Regulation and the Chief Executive Officer of NASD) or a National Adjudicatory Council 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 Director or member or 20 percent or more of the gross revenues received by the Director's or 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 Director or member or 20 percent or more of the gross revenues received by the Director's or member's firm or partnership; or (6) has a consulting or employment relationship with or provides professional services to the NASD, NASD Regulation, [Nasdaq,] NASD Dispute Resolution, or [Amex (and any Predecessor),] a market for which NASD provides regulation, or has had any such relationship or provided any such services at any time within the prior three years;

\* \* \* \* \*

(y) "Non-Industry Director" or "Non-Industry member" means a Director (excluding the President of NASD Regulation and the Chief Executive Officer of NASD) or a National Adjudicatory Council or committee member who is (1) a Public Director or Public member; (2) an officer or employee of an issuer of securities listed on [Nasdaq or Amex,] a market for which NASD provides regulation; (3) an officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market; or [(3)](4) any other individual who would not be an Industry Director or Industry member;

\* \* \* \* \*

(aa) "Public Director" or "Public member" means a Director or National Adjudicatory Council or committee member who has no material business relationship with a broker or dealer or the NASD, NASD Regulation, or [Nasdaq,] a market for which NASD provides regulation;

\* \* \* \* \*

[(dd) "Floor Governor" or "Amex Floor Governor" means a Floor Governor of Amex elected pursuant to Article I, Section 01(a) of the Amex By-Laws;

(ee) "Nasdaq-Amex" means Nasdaq-Amex Market Group, Inc.;

(ff) "Amex" means American Stock Exchange LLC;

(gg) "Amex Board" means the Board of Governors of Amex;]

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**ARTICLE IV**

**BOARD OF DIRECTORS**

\* \* \* \* \*

**Sec. 4.14 (a) Conflicts of Interest; Contracts and Transactions Involving Directors**

**Sec. 4.14 (a)** A Director or a National Adjudicatory Council or committee member shall not directly or indirectly participate in any adjudication of the interests of any party if that Director or National Adjudicatory Council 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 Director or National Adjudicatory Council 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 NASD Regulation and one or more of its Directors or officers, or between NASD Regulation and any other corporation, partnership, association, or other organization in which one or more of its Directors 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 Director'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 Directors; (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 Directors; or (iii) the material facts pertaining to the Director's or officer's relationship or interest and the contract or transaction are disclosed or are known to the stockholder entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the stockholder. Only disinterested Directors 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 a contract or transaction between NASD Regulation and[:] the NASD, NASD Dispute Resolution, or Nasdaq[, Nasdaq-Amex, or Amex].

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**PROPOSED AMENDMENTS TO BY-LAWS OF  
NASD DISPUTE RESOLUTION, INC.**

**ARTICLE I**

**DEFINITIONS**

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

(a) “Act” means the Securities Exchange Act of 1934, as amended;

(b) “Amex” means American Stock Exchange LLC;

(b) [(c)] “Board” means the Board of Directors of NASD Dispute Resolution;

(c) [(d)] “broker” shall have the same meaning as in Section 3(a)(4) of the Act;

(d) [(e)] “Commission” means the Securities and Exchange Commission;

(e) [(f)] “day” means calendar day;

(f) [(g)] “dealer” shall have the same meaning as in Section 3(a)(5) of the Act;

(g) [(h)] “Delaware law” means the General Corporation Law of the State of Delaware;

(h) [(i)] “Delegation Plan” means the “Plan of Allocation and Delegation of Functions by NASD to Subsidiaries” as approved by the Commission, and as amended from time to time;

(i) [(j)] “Director” means a member of the Board, excluding the Chief Executive Officer of the NASD;

(j) [(k)] “Executive Representative” means the executive representative of an NASD member appointed pursuant to Article IV, Section 3 of the NASD By-Laws;

(k) [(l)] “Industry Director” or “Industry member” means a Director (excluding the President) or a 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 Director or member or 20 percent or more of the gross revenues received by the Director's or 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 Director or member or 20 percent or more of the gross revenues received by the Director's or member's firm or partnership; or (6) has a consulting or employment relationship with or provides professional services to the NASD, NASD Regulation, [Nasdaq,] NASD Dispute Resolution, or [Amex (and any predecessor),] a market for which NASD provides regulation, or has had any such relationship or provided any such services at any time within the prior three years;

(l) [(m)] "NASD" means the National Association of Securities Dealers, Inc.;

(m) [(n)] "NASD Board" means the NASD Board of Governors;

(n) [(o)] "NASD Dispute Resolution" means NASD Dispute Resolution, Inc.;

(o) [(p)] "NASD member" means any broker or dealer admitted to membership in the NASD;

(p) [(q)] "NASD Regulation" means NASD Regulation, Inc.;

(q) [(r)] "Nasdaq" means The Nasdaq Stock Market, Inc.;

[(s)] "Nasdaq-Amex" means Nasdaq-Amex Market Group, Inc.;

(r) [(t)] "National Nominating Committee" means the National Nominating Committee appointed pursuant to Article VII, Section 9 of the NASD By-Laws;

(s) [(u)] "Non-Industry Director" or "Non-Industry member" means a Director (excluding the President) or committee member who is (1) a Public Director or Public member; (2) an officer or employee of an issuer of securities listed on [Nasdaq or Amex, or] a market for which NASD provides regulation; (3) an officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market; or [(3)](4) any other individual who would not be an Industry Director or Industry member;

(t) [(v)] "person associated with a member" or "associated person of a member" means: (1) a natural person registered under the Rules of the Association; or (2) a sole

proprietor, partner, officer, director, or branch manager of a member, or a natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with the NASD under these By-Laws or the Rules of the Association;

(u) [(w)] “Public Director” or “Public member” means a Director or committee member who has no material business relationship with a broker or dealer or the NASD, NASD Regulation, [Nasdaq,] a market for which NASD provides regulation, or NASD Dispute Resolution;

\* \* \* \* \*

(v) [(x)] “Rules of the Association” or “Rules” means the numbered rules set forth in the NASD Manual beginning with the Rule 0100 Series, as adopted by the NASD Board pursuant to the NASD By-Laws, as hereafter amended or supplemented.

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## **ARTICLE IV**

### **BOARD OF DIRECTORS**

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#### **Conflicts of Interest; Contracts and Transactions Involving Directors**

**Sec. 4.14** (a) A Director or a committee member shall not directly or indirectly participate in any determinations regarding the interests of any party if that Director 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 Director 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 NASD Dispute Resolution and one or more of its Directors or officers, or between NASD Dispute Resolution and any other corporation, partnership, association, or other organization in which one or more of its Directors 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 Director'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 Directors; (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 Directors; or (iii) the material facts pertaining to the Director's or officer's relationship or interest and the contract or transaction are disclosed or are known to the stockholder entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the stockholder. Only disinterested Directors 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 a contract or transaction between NASD Dispute Resolution and the NASD, NASD Regulation, or Nasdaq[, Nasdaq-Amex, or Amex].

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II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The proposed rule change will reverse a number of changes that NASD made to the By-laws of NASD, NASD Regulation, and Dispute Resolution in 1998, when NASD acquired Amex. In addition, NASD proposes to withdraw certain representations it made in 1998 regarding its relationship with Amex following the Amex acquisition. Finally, NASD proposes to make certain other clarifying changes.

### **Proposed By-Law Revisions**

The proposed By-law changes are discussed briefly below. Where noted, parallel changes will be made to the By-laws of NASD Regulation and Dispute Resolution.

#### ***Article I (Definitions)***

The amendments will eliminate references to both Amex and Nasdaq from the definitions of “Industry Director,” “Industry Governor,” “Non-Industry Director,” and “Non-Industry Governor,” “Public Director,” and “Public Governor.” The current references to Nasdaq and Amex will be replaced with references to “a market for which NASD provides regulation.” 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 “a market for which NASD provides regulation,” a term that embraces both markets with which NASD has entered a contract to provide regulatory services, and those in which NASD has an ownership interest. Because NASD has entered into a regulatory services agreement with Amex, and continues both to maintain an ownership interest in and to provide regulatory services to Nasdaq, the amended definition of “Industry Governor” will continue to encompass individuals who have a consulting or employment relationship with Amex or Nasdaq. NASD believes that, given the difficulty and expense involved in amending the NASD By-Laws when regulatory clients are added or deleted, substituting “a market for which NASD provides regulation” is preferable to identifying such clients by name in the By-Laws.

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.” Historically, NASD has interpreted this provision as applying only to officers and employees of unlisted securities traded in the over-the-counter market: NASD has never applied the provision to include officers and employees of listed securities that were traded off-exchange. However, since both listed and unlisted securities may be traded in the over-the-counter market, Article I, Sections (bb) and (cc) have been amended to reflect NASD’s historical interpretation of the definitions. The proposed amendments make no substantive change to the definitions; rather, the amendments simply seek to clarify that (renumbered) Subsections 3 of the “Non-Industry Director” and “Non-Industry Governor” definitions include an officer or employee of only an issuer of unlisted securities that are traded exclusively in the over-the-counter market.

Finally, the definitions of and references to “Floor Governor,” “Amex,” and “Amex Board” have been eliminated.

Parallel changes are proposed for the definitional provisions of the NASD Regulation and Dispute Resolution By-Laws.

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

The proposed amendments will eliminate two seats on the NASD Board that have been reserved for the Chief Executive 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.

The proposed amendments will leave unchanged the existing requirement that the NASD Board include a minimum of four to six Public Governors. However, the numeric thresholds for these minimums will be adjusted downward to reflect the smaller overall Board size. For example, the By-Laws currently require a minimum of four Public Governors when the combined number of Industry and Non-Industry Governors is 15 to 17; under the proposed amendments, a minimum of four Public Governors will be required when the combined number of Industry and Non-Industry Governors is 13 to 15.

No change is proposed to the existing requirement that the number of Non-Industry Governors exceed the number of Industry Governors.

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, NASD has repeatedly stated a preference to avoid filling all authorized seats if the compositional requirements set forth in the By-Laws can be met without the maximum permissible number of Governors.

In addition, 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, and eliminate the requirement that an Amex representative be included on the committee. The proposed amendments also will eliminate the current requirement that at least two members of the committee be members of neither the Amex nor NASD Regulation boards. NASD notes that requiring at least two NASD-only members of the Executive Committee appears to have responded to concerns that arose when there were multiple subsidiaries (at various times Nasdaq, Amex, and/or NASD Regulation) that were entitled to representation on both the NASD Board and the Executive Committee.<sup>5</sup>

NASD notes that avoiding possible domination of NASD affairs by market interests, and a corresponding diminution of NASD regulatory responsibilities, has represented a primary consideration in NASD corporate governance since the Select Committee Report was issued in 1995. With the elimination of “status” seats reserved for Nasdaq and Amex representatives, however, NASD believes concerns that these markets could dominate NASD decision-making also are eliminated.

The elimination of mandatory market representation on the Executive Committee will leave NASD Regulation as the sole remaining subsidiary entitled to be represented on the committee. Under the proposed rule change, NASD Regulation will continue to be entitled to

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<sup>5</sup> In 1997, NASD made extensive modifications to its corporate documents in response to the Report of the Select Committee on Structure and Governance to the NASD Board of Governors (Select Committee Report) and the Commission’s 1996 Report Pursuant to Section 21(a) of the Act (Section 21(a) Report). Among other things, Article IX, Section 4 was amended to authorize the appointment of the Executive Committee. The 1997 amendments included requirements that: (i) Nasdaq and NASD Regulation be represented on the committee; and (ii) at least two of the committee members not be affiliated with those subsidiaries. See Exchange Act Release No. 39326 (Nov. 14, 1997), 62 F.R. 62385 (November 21, 1997). Following the acquisition of Amex in 1998, Amex was added to the entities entitled to representation on the Committee. See Exchange Act Release No. 40622 (Oct. 30, 1998), 63 F.R. 59819 (November 5, 1998). Nasdaq’s right to representation on the committee was terminated in 2001. See Exchange Act Release No. 44280 (May 8, 2001), 66 F.R. 26892 (May 15, 2001).



at least one representative on the Executive Committee. However, because NASD believes the possibility that regulatory interests could improperly dominate NASD decision making would not raise the same concerns as the possibility of market-interest domination, the proposed amendments do not specify any minimum number of NASD-only Governors who must be included on the Executive Committee. NASD believes that the proposed changes to the Executive Committee composition are consistent with the Select Committee Report and the Section 21(a) Report.

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

Subsection 4(b) of Article XV governs participation in transactions in which Governors have a conflict of interest. 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. As a result of this change, an Amex-affiliated Governor could no longer be counted as disinterested for purposes of determining the presence of a quorum at the portion of a meeting of the Board that authorizes a contract or transaction with Amex.

Parallel changes are proposed for the conflict-of-interest provisions of the NASD Regulation and Dispute Resolution By-laws.

**1998 Undertakings Regarding NASD-Amex Relationship**

In 1998, NASD articulated certain principles that would guide the organization in fulfilling its responsibilities as parent company of Amex with ultimate responsibility for Amex's compliance with its statutory responsibilities as a self-regulatory organization

("SRO").<sup>6</sup> Upon completion of NASD's divestiture of its ownership interest in Amex, these principles will no longer be applicable. Instead, the NASD-Amex relationship will be governed by the regulatory services agreement into which the organizations have entered. Because the Commission approved the 1998 undertakings as NASD rules,<sup>7</sup> NASD now seeks the Commission's approval of the withdrawal of the undertakings.

## 2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(4) of the Act which requires, among other things, that NASD's rules assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of NASD, broker or dealer. NASD also believes the proposed rule change is consistent with Section 15A(b)(6) of the Act, which requires that NASD's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and protect investors and the public interest.

### (B) Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change, as amended, will result in any

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<sup>6</sup> Among other things, NASD represented that it would exercise its powers and its managerial influence to ensure that Amex fulfilled its self-regulatory obligations by directing Amex to take action necessary to effectuate its purposes and functions as a national securities exchange operating pursuant to the Act, and ensuring that Amex had and appropriately allocated such financial, technological, technical, and personnel resources as may be necessary or appropriate to meet its obligations under the Act. NASD also committed to refraining from taking any action with respect to Amex that would impede efforts by Amex to carry out its SRO obligations. See File No. SR-NASD-98-67 – Policies Regarding Authority Over American Stock Exchange LLC and Composition of Board of Governors of American Stock Exchange LLC (Sept. 11, 1998).

burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Comments also may be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. SR-NASD-XXXX-XX. This file number should be included on the subject line if e-mail is used. To help us process and review comments

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<sup>7</sup> See Exchange Act Release No. 40622 (Oct. 30, 1998), 63 F.R. 59819 (November 5, 1998) (describing NASD's undertakings regarding Amex).

more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Margaret H. McFarland  
Deputy Secretary