



July 16, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File No. SR-NASD-2007-023 – Supplemental Response to Comments

Dear Ms. Morris:

This letter responds to certain comments received by the Securities and Exchange Commission ("SEC," or "Commission") regarding the above-referenced filing, a proposed rule change to amend the By-Laws of NASD ("By-Laws," or "NASD By-Laws"). The proposed rule change would implement governance and related changes to accommodate the planned consolidation of the member firm regulatory operations of NASD and NYSE Regulation, Inc. ("NYSE Regulation") into NASD, operating under a new name, the Financial Industry Regulatory Authority ("FINRA"). The proposed rule change was published for comment in the Federal Register on March 26, 2007.¹

In separate letters, NASD has already responded to comments on various aspects of the By-Law changes, the By-Law approval process, and FINRA's arbitration forum.² This letter responds to two issues raised in subsequent comments: (1) allegations that NASD members could have received much more—over eight times as much, according to one commenter—than the \$35,000 they would each receive if the Commission approves the By-Law amendments and the consolidation is eventually completed³; and (2) an assertion that member approval of the

¹ Securities Exchange Act Release No. 55495 (March 20, 2007), 72 FR 14149 (March 26, 2007).

² Letter from Patrice M. Gliniecki, NASD, to Nancy Morris, Commission (May 29, 2007); Letter from Linda D. Fienberg, NASD, to Nancy Morris, Commission (May 29, 2007).

³ See, e.g., Letter from Jonathan W. Cuneo and Richard D. Greenfield to Nancy Morris (June 11, 2007).

proposed By-Laws amendments at a special meeting violated the NASD By-Laws.⁴ As the following discussion makes clear, both of these contentions lack merit.

The \$35,000 Member Payment

NASD is a Delaware nonstock membership corporation exempt from U.S. federal income tax under Section 501(c)(6) of the Internal Revenue Code. Section 501(c)(6) forbids any of NASD's net earnings or revenues from inuring to the benefit of members. Under this provision, NASD would forfeit its tax-exempt status if it paid even \$1 in dividends to its members.⁵

As the letter from William J. Haubert, Esq., of Richards, Layton & Finger, P.A., submitted herewith explains, NASD's certificate of incorporation, which is filed with the Commission, contains a provision very similar to Section 501(c)(6). The certificate specifies that NASD "shall not be conducted for profit" and that "no part of its net revenues or earnings shall inure to the benefit of any individual, subscriber, contributor, or member." Any action that violates Section 501(c)(6) would also violate this provision. Under Delaware law, a corporation cannot engage in any action that would violate its certificate. Therefore, NASD could not structure the proposed transaction, including the member payments, in a way that would violate Section 501(c)(6).

The proposed \$35,000 member payments do not violate Section 501(c)(6) or NASD's certificate of incorporation, however, because they do not represent a dividend or comparable distribution of NASD's assets or "Members' Equity." Rather, as NASD noted in its initial response to comments, the proposed member payments are based on (and limited by) expected future incremental cash flows that would result from the regulatory consolidation. The assertions of some commenters that the proposed \$35,000 payments are not so limited, and that NASD can and should distribute its "Members' Equity," in larger payments of up to \$300,000 per member, are simply incorrect. The combined effect of the prohibition against inurement to members of a tax-exempt organization (as outlined in the letter from Mario J. Verdolini, Esq., of Davis Polk & Wardwell, submitted herewith) and of the certificate provision (as described in Mr. Haubert's letter) makes such an "equity" distribution impermissible.

Moreover, in structuring the transaction, NASD believed that NASD members—who had borne financial burdens associated with duplicative regulation for decades—should benefit from

⁴ See, e.g., Comments of Jack D. Jester (June 4, 2007).

⁵ See 26 U.S.C. § 501(c)(6) (requirement that "no part" of an exempt entity's net earnings inure to any private shareholder or individual); I.R.S. Gen. Couns. Mem. 39862 (Nov. 22, 1991) ("There is no de minimis exception to the inurement prohibition."); see also *Spokane Motorcycle Club v. United States*, 222 F. Supp. 151, 153-54 (E.D. Wash. 1963) (refreshments provided at no cost to club members invalidated tax exemption).

the future efficiencies that would be created by the proposed regulatory consolidation. But, as noted above, any direct payment unrelated to those efficiencies would be inconsistent with NASD's tax-exempt status. As NASD explained in the proxy statement, NASD was not willing to take any action that could "seriously jeopardize" that status. Accordingly, obtaining a private letter ruling from the Internal Revenue Service ("IRS") approving the proposed regulatory consolidation as consistent with NASD's tax exemption was a precondition to closing.⁶

As Mr. Verdolini's letter explains, NASD's request for a private letter ruling raised a number of difficult doctrinal issues. After considering these issues, public IRS guidance, the terms of the initial agreement between NASD and NYSE Group, Inc., and the importance of preserving NASD's tax-exempt status, NASD concluded that \$35,000 was the maximum member payment that the IRS could be expected, with a sufficient degree of confidence, to approve within the timeframe contemplated for the transaction. NASD reached this conclusion, and decided to request the IRS's approval of the regulatory consolidation including a \$35,000 payment, through the exercise of business judgment by its disinterested Board of Governors. A majority of the Board is drawn from outside the securities industry; no Board member had any material conflict in connection with the proposed regulatory consolidation; and no member was dominated by anyone else with such a conflict. And the Board members fully informed themselves concerning the economics of the transaction (in particular the projected cost savings), the practical need for IRS approval, and the likelihood of obtaining that approval before determining that \$35,000 was the maximum sum for which NASD could seek and expect to obtain approval from the IRS. The Board's decision was taken in good faith and in full compliance with the Board members' fiduciary duties, and the resulting business judgment is entitled to deference.

Pursuant to that business judgment, NASD requested a private letter ruling from the IRS approving the proposed regulatory consolidation, including a one-time payment in that amount based on expected future incremental cash flows, examined in conjunction with other costs attributable to the transaction (including future dues rebates to be considered annually by the NASD Board over the following five years). It was on this basis that the IRS agreed to issue such a ruling.

Therefore, the proxy materials accurately state that member payments in excess of \$35,000 would not be possible because such a payment, without the IRS's approval, could "seriously jeopardize" NASD's tax-exempt status. Commenters' assertions to the contrary ignore the limitations imposed by NASD's tax-exempt status and the necessity of obtaining prompt IRS approval of the proposed payment.

⁶ As stated in the proposed rule change, NASD received a favorable ruling by the IRS that the transaction will not affect the tax-exempt status of NASD or NASD Regulation, Inc. Also, as stated in the proposed rule change, on March 7, 2007, NASD and NYSE Group, Inc. filed notification reports with the Department of Justice and the Federal Trade Commission under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. The waiting period for such filing expired on April 6, 2007.

The By-Law Approval Procedure

As already explained in NASD's submission dated May 29, 2007, the proposed amendments to the By-Laws were approved at a special meeting of NASD members, held pursuant to Article XXI of the By-Laws. One commenter has submitted a supplemental letter insisting that NASD members' residual power to amend the By-Laws (subject to the Commission's review), and to do so at a special meeting, is limited by another provision of the By-Laws, Article XVI. Accordingly, this commenter insists, NASD is not permitted to give its members any more than 30 days to consider and vote on a proposed By-Law amendment.

As NASD has already explained, that reading of the By-Laws is incorrect. Mr. Haubert's letter explains the relevant principles of corporate law that empower NASD members to take action on By-Law amendments at a special meeting. Reading the NASD By-Laws in harmony with each other, and with these principles of corporate law, makes clear that NASD acted entirely properly by permitting its members more than 30 days to consider and vote on these proposed By-Law amendments at the special meeting.

Other Issues

In response to comments raised by SEC staff, NASD is advising the Commission that the Charter of FINRA's Nominating Committee provides that at least 20% of the Nominating Committee will be composed of Industry Governors who are associated with members of FINRA. In addition, FINRA will continue extensive member involvement in the administration of its affairs through representation on various subject matter committees, disciplinary hearing panels and the National Adjudicatory Council. Such member participation includes, depending on the particular Committee or group, having input on FINRA's rulemaking process and involvement in the disciplinary process.

The SEC staff also has inquired as to the status of FINRA's adoption of a single, consolidated rulebook applicable to all of its members. NASD expects that FINRA would submit to the Commission within one year of the date of closing of the transaction proposed rule changes that would constitute a significant portion of the consolidated rulebook, with the remaining sections being submitted to the Commission within two years of the closing date.

NASD believes that the foregoing fully responds to the issues raised by the supplemental comments on the proposed rule change. If you have any questions, please call me at (202) 728-8285.

Very truly yours,



T. Grant Callery

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July 16, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 "F" Street, NE
Washington, DC 20549-1090

Re: **Proposed Changes to NASD By-Laws: File No. SR-NASD-2007-023**

Dear Ms. Morris:

I submit this letter in regard to (i) the proposed changes to the by-laws (the "By-Laws") of National Association of Securities Dealers, Inc. ("NASD"), a Delaware membership corporation, which were submitted to NASD's members ("Members") through a proxy statement dated December 14, 2006 and (ii) the proposed \$35,000 payment (the "Member Payment") that will be made to the Members which will be paid in conjunction with the proposed consolidation (the "Proposed Transaction") of NASD's regulatory activities with those of NYSE Regulation, Inc. The proposed changes to the By-Laws are a precondition of the Proposed Transaction's closing, and the Member Payment would be made in connection with the closing.

The proposed changes to the By-Laws have been approved by NASD's board of directors (the "Board") and by (and approved by an overwhelming majority of) the Members at the special meeting of Members held on January 19, 2007 (the "Special Meeting"). The proposed changes to the By-Laws have been submitted to the Securities and Exchange Commission (the "SEC") for its approval.

I understand that Article IV of the Restated Certificate of Incorporation of NASD ("Certificate") provides that members have no voting rights except as provided by the General Corporation Law of the State of Delaware ("DGCL") or the Certificate, and that Members shall be entitled to amend the NASD By-Laws. I also understand that Article XVI of the By-Laws establishes a procedure whereby Members are sent copies of proposed amendments to the By-Laws, and if the proposed amendments are approved by a majority of the Members voting within

thirty (30) days and, thereafter, approved by the SEC, the proposed amendments become effective.¹

In the course of the SEC's review, questions have been raised concerning (i) whether it is within the authority of the Members to approve proposed amendments to the By-Laws, as done here, at a special meeting held more than thirty days after the proposed By-Laws had been submitted to the Members and (ii) whether a larger Member Payment would be permitted under Delaware law. For the reasons and subject to the assumptions and limitations set forth below, it is my view that (i) the Members' vote at the Special Meeting approving the proposed amendments to the By-Laws was a valid exercise of the Members' franchise rights and authorized by Delaware law and (ii) a larger Member Payment would not be permitted under Delaware law.

Approval by Members of Proposed Changes to By-Laws

Section 211(a) of the DGCL provides that "meetings of stockholders may be held at such place ... as may be designated by or in the manner provided in the certificate of incorporation or bylaws" 8 *Del. C.* § 211(a); *see also id.* § 215(a) (providing that Section 211(a) applies to membership corporations notwithstanding its use of "stockholders" rather than "members"). Because Section 211(a) speaks broadly to "meetings" without any limitation, it encompasses both "annual meetings" and "special meetings." *Compare* 8 *Del. C.* § 211(a) (using "meetings" without limitation), *with* 8 *Del. C.* § 211(c) (controlling "annual meetings," as opposed to "meetings"), *with* 8 *Del. C.* § 211(d) (controlling "special meetings," as opposed to "meetings"). Thus, Section 211(a) plainly applies to all NASD meetings.

On January 19, 2007 NASD held a meeting of its Members. That meeting was called under the authority of Article XXI, Section 2 of the By-Laws.² It was properly noticed, and the requisite quorum was in attendance. At that meeting, the Members voted to amend the By-Laws. The power of stockholders or members to modify the by-laws of a Delaware corporation is plenary. Section 109(a) of the DGCL states:

¹ By-Laws of National Association of Securities Dealers, Inc. art. XVI, § 1 available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000026 ("The Board, upon adoption of any such amendment to these By-Laws, except as to spelling or numbering corrections or as otherwise provided in these By-Laws, shall forthwith cause a copy to be sent to and voted upon by each member of the NASD. If such amendment to these By-Laws is approved by a majority of the members voting within 30 days after the date of submission to the membership, and is approved by the Commission as provided in the Act, it shall become effective as of such date as the Board may prescribe.").

² *See* By-Laws, *supra* note 1, art. XXI, § 2 ("A special meeting shall be on such date and at such place as the Board shall designate. Only such business shall be conducted at a special meeting as shall have been brought before the meeting pursuant to [notice]").

[T]he power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote, or, in the case of a nonstock corporation, in its members entitled to vote; provided, however, any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors or, in the case of a nonstock corporation, upon its governing body by whatever name designated. The fact that such power has been so conferred upon the directors or governing body, as the case may be, shall not divest the stockholders or members of the power, nor limit their power to adopt, amend or repeal bylaws.

8 *Del. C.* § 109(a) (emphasis added). Section 109(a) is a mandatory provision of the DGCL. Thus the power to amend the By-Laws is conferred on the Members.

Because the Members may meet, as they could on January 19, 2007 per Section 211 of the DGCL, and because those Members have the power to amend the By-Laws, as the NASD Members do per Section 109, then it follows that at that meeting the Members' vote to modify the By-Laws was a valid expression of power expressly conferred by the DGCL. Moreover, under Delaware law that mandatory power of Members to amend the By-Laws cannot be limited by any charter provision, much less by any mere by-law. If a corporate by-law purports to nullify a mandatory provision of the DGCL, then, as a matter of Delaware law, it is void in this respect. *See generally SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947) (holding that a by-law precluding stockholder action at a duly noticed meeting would be void under Delaware law).

Moreover, there is nothing to suggest that Article XVI was intended to be the exclusive method by which Members modify the By-Laws. There is no language in Article XVI purporting to be the express means by which Members might amend the By-Laws. There is no language in Article XVI purporting to limit Members' powers to take any action at any meeting, special meeting or annual meeting, or by consent. Such language would have been easy to include, but it was not included. Moreover, such an interpretation would undermine the very purpose of meetings under Delaware law. Under Delaware law, a meeting is much more than a place of debate whereby information and points of view are exchanged; rather, a meeting is the place where the members' voice is actually heard and there the members' power to control the corporation's destiny is exercised. *See, e.g., Perlegos v. Atmel Corp.* C.A. No. 2320-VCN, 2007 WL 475453 (Del. Ch. Feb. 8, 2007) ("Along with the [stockholder's] right to vote, the forum in which shareholders exercise this right plays a fundamentally important role in the corporate governance structure established under the DGCL. In short, a stockholders meeting is an important event on the corporate calendar.") (emphasis added); *see also* 5 Wm. Meade Fletcher, *Fletcher Cyclopedic of the Law of Private Corporations* § 1996, at 4 (rev. ed. 2003) ("[M]eetings of the shareholders or members are the sole and necessary regular modes of choosing corporate officers and determining fundamental questions that are beyond the competency of directors or officers.").

The better view, in my opinion, is that Article XVI is not the exclusive means by which the By-Laws might be amended. In these circumstances, the power of Members to act at a meeting is left intact and the January 19, 2007 vote was valid and takes effect. Delaware law clearly favors this view, which leaves intact the January 19, 2007 vote, supported by an overwhelming majority of the Members. Essentially, this view provides Members with multiple means by which to participate in corporate governance. In other words, this view furthers the ends of corporate democracy. See *Openwave System Inc. v. Harbinger Capital Partners Master Fund I, Ltd.*, C.A. No. 2690-VCL, 2007 WL 704943, at *2 (Del. Ch. Mar. 5, 2007) ("This court and Delaware law are especially solicitous of the franchise rights of stockholders"); *Openwave System Inc. v. Harbinger Capital Partners Master Fund I, Ltd.*, C.A. No. 2690-VCL, 2007 WL 1500034, at *8 (Del. Ch. May 18, 2007) ("If the language [within a corporate by-law] is found to be ambiguous doubt is resolved in favor of the stockholders' electoral rights."); see also *Hoschett v. TSI Int'l Software, Ltd.*, 683 A.2d 43, 44 (Del. Ch. 1996) (Allen, C.) (noting "[t]he critical importance of shareholder voting both to the theory and to the reality of corporate governance"). Moreover, Delaware courts, as courts in every jurisdiction, have indicated time and again that by-laws (and other legal instruments) should be interpreted in a manner consistent with the DGCL. See, e.g., *Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401, 407 (Del. 1985) ("[T]he courts will construe the bylaws in a manner consistent with the law rather than strike down the bylaws. A bylaw that is inconsistent with any statute or rule of common law, however, is void") (citing Fletcher, *supra*, §§ 4184-85 (rev. ed. 1982)). Indeed, in my view, By-Law amendments approved, as here, pursuant to a Section 109(a) member vote at a meeting have independent legal significance (once approved by the SEC), and their validity is not tested by the strictures of the By-Law amendment process that arises by operation of Article XVI or, for that matter, by the process for member action by consent under DGCL Section 228. See generally *Orzech v. Englehart*, 195 A.2d 375, 376-77 (Del. 1963) ("The mere fact that the result of actions taken under one section may be the same as the result of action taken under another section does not require that the legality of the result must be tested by the requirements of the second section."). This is a core principle, if not the core principle, of Delaware corporation law.

Amount of Member Payment

Next, with respect to whether a larger Member Payment could have been made by NASD, a membership non-profit corporation organized in the State of Delaware,³ one must first consider Article 4 of the Certificate, which states:

NASD shall be a membership corporation and shall have no capital stock. NASD is not organized and shall not be conducted for profit, and no part of its net

³ See Restated Certificate of Incorporation of NASD, Inc. (filed with Delaware Secretary of State on Feb. 2, 2005).

revenues or earnings shall inure to the benefit of any individual, subscriber, contributor, or member.⁴

In defining NASD's powers in this regard, Article 4's chosen language tracks that of the federal income tax code (the "Code"). *See, e.g.*, 26 U.S.C. § 501(c)(6) ("The following organizations are [exempt from taxation]: Business leagues ... [and] boards of trade, not organized for profit [where] no part of the net earnings of which inures to the benefit of any private shareholder or individual."); *see also, e.g.*, Tariff Act of 1909, ch. 6, § 38, 36 Stat. 112. Thus, any violation of the Code would violate the Certificate.

The DGCL is an enabling statute that affords Delaware corporations the ability to engage in a wide array of actions, if the corporation opts into this framework in its certificate of incorporation. *See* 8 Del. C. § 102(a)(3) ("It shall be sufficient to state, either alone or with other businesses or purposes, that the purpose of the corporation is to engage in any lawful act or activity"). However, such authority can be limited by the corporation's certificate of incorporation. In this respect, Delaware courts have repeatedly held that a Delaware corporation does not have the authority to engage in activities prohibited by its certificate of incorporation.⁵

I understand that there would have been a serious risk of violating the Code's prohibition against private inurement if a larger Member Payment were made. Any action in contravention of the Code's prohibition against inurement would also be in contravention of the prohibition against inurement set forth in the Certificate. Any such action would, therefore, be void under Delaware law.

Conclusions

Based upon and subject to the foregoing, and subject to the limitations stated below, I conclude that (i) the January 19, 2007 Member vote approving the proposed By-Law amendments was a valid exercise of the Members' franchise rights and authorized by Delaware law and (ii) because the Certificate contains a prohibition against inurement, if a payment by NASD in excess of the contemplated Member Payment would violate the Code's prohibition against inurement, any such payment also would be void under Delaware law.

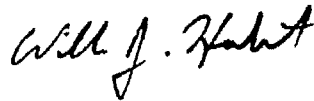
⁴ *Id.* art. 4.

⁵ *See, e.g., Lions Gate Entm't Corp. v. Image Entm't Inc.*, C.A. No. 2011-N, 2006 WL 1668051, at *7 (Del. Ch. June 5, 2006) (holding that by-law provision in excess of authority conferred by charter "is invalid, *ultra vires*, and void."); *Solomon v. Armstrong*, 747 A.2d 1098, 1114 n.45 (Del. Ch. 1999) (describing "ultra vires" acts as those "acts specifically prohibited by the corporation's charter, for which no implicit authority may be rationally surmised"); *see also, e.g., Black's Law Dictionary* (7th ed. 1999) (defining "ultra vires" as "unauthorized: beyond the scope of power allowed or granted by a corporate charter").

Ms. Nancy M. Morris
July 16, 2007
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In the event that you or your SEC colleagues have any questions with respect to this letter, do not hesitate to contact me at (302) 651-7559. I understand that you or your SEC colleagues may make this letter public in connection with the matters addressed herein and I consent to your doing so. However, this letter may not be relied upon by any other person or entity for any purpose without prior written consent from Richards, Layton & Finger, P.A.

Sincerely,

A handwritten signature in black ink, appearing to read "Will J. Haubert". The signature is written in a cursive, flowing style.

William J. Haubert

cc: Seth Barrett Tillman

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July 16, 2007

Re: **File No. SR-NASD-2007-023 – U.S. Federal Income Tax
Considerations**

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Dear Ms. Morris:

On behalf of the National Association of Securities Dealers, Inc. (“**NASD**”) and NASD Regulation, Inc. (“**NASDR**”), I am writing to describe generally the case law, statutory provisions and guidance published by the Internal Revenue Service (the “**IRS**” or the “**Service**”) relevant to the disclosure in NASD’s December 14, 2006, proxy statement (the “**Proxy Statement**”) that it was not possible to increase the one-time \$35,000 payment that would be made to NASD members (the “**Member Payment**”) in connection with the proposed consolidation of NASD’s member regulatory activities with those of NYSE Regulation, Inc. (“**NYSE Regulation**” and such transaction, the “**Proposed Transaction**”).

By way of background, the tax law contains an absolute prohibition on a distribution of assets by tax-exempt organizations, including NASD, to their members. Although there are limited exceptions to that prohibition, none of them clearly applies here. Thus, there are no authorities directly on point that would allow NASD to make the contemplated Member Payment without jeopardizing its tax exemption. As a result, the only way that NASD could make the proposed Member Payment was by securing a private letter ruling from the IRS to the effect that the Proposed Transaction – including the Member Payment – would not affect its tax exemption. In order to maximize its chance of securing an IRS ruling in a timely manner that would not delay the closing of the Proposed

Transaction, NASD filed a ruling request with the IRS on October 26, 2006 and amended that request to state the amount of the proposed Member Payment on November 27, 2006. After NASD made additional submissions responding to questions raised by the IRS, the IRS issued the ruling.

Discussion

NASD's charter makes clear that NASD members have no claim to NASD's equity. NASD's tax-exempt status under federal law creates a similar prohibition on member claims to NASD's equity.

It is clearly and consistently articulated in numerous court decisions and IRS rulings over the course of decades that an entity such as NASD, which is recognized by the Service as exempt from U.S. federal income tax, may not pay any dividends or otherwise confer any part of its earnings to its members without losing its tax exemption. In fact, this prohibition against "private inurement" is so foundational to U.S. tax law that it originates in the Corporate Excise Tax of 1909, predating by four years the ratification of the Sixteenth Amendment that made a federal income tax constitutional. See Tariff Act of 1909, ch. 6, § 38, 36 Stat. 112. This prohibition today appears in several places in the Internal Revenue Code, including in Section 501(c)(6), which authorizes an exemption from tax for business leagues, chambers of commerce and similar organizations like NASD and NASDR that are "not organized for profit and *no part* of the net earnings of which inures to the benefit of any private shareholder or individual" (emphasis added). The Service and courts have repeatedly determined that this prohibition is an absolute: "There is no *de minimis* exception to the inurement prohibition." Gen. Couns. Mem. 39862 (1991); *Beth-El Ministries, Inc. v. United States*, 44 A.F.T.R. 2d 79-5190 (D.D.C. 1979) ("Even if the benefit inuring to the members is small, it is still impermissible"); see also *McGahen v. Commissioner*, 76 T.C. 468 (1981), *aff'd*, 720 F.2d 664 (3d Cir. 1983); *Unitary Mission Church v. Commissioner*, 74 T.C. 507 (1980), *aff'd*, 647 F.2d 163 (2d Cir. 1981); *Gookin v. United States*, 707 F. Supp. 1156 (N.D. Cal. 1988). Because the inurement of a single dollar of an exempt entity's net earnings to its shareholders or members invalidates its exemption, seemingly minor improprieties have been the basis for revocation. See, e.g., *Spokane Motorcycle Club v. United States*, 222 F. Supp. 151 (E.D. Wash. 1963) (tax exemption revoked for sponsoring the cost of refreshments provided to club members).

Notwithstanding the absolute prohibition against the private inurement of an exempt organization's net earnings, there are certain very narrowly drawn circumstances in which a payment can be made to members and will not actually constitute inurement. None of these exceptions clearly authorizes the proposed Member Payment.

Rebates of Dues or Fees. An organization exempt from tax under Section 501(c)(6) may rebate fees paid in by its members. See Rev. Rul. 81-60, 1981-1 C.B. 335 ("[I]t is well established that a business league or other organization

exempt under § 501(c)(6) may refund part of the dues or contributions previously paid to the organization for its activities. Such refunds are treated as reductions in dues.”); *see also* Priv. Ltr. Rul. 8226013 (1981), Rev. Rul. 77-206, 1977-1 C.B. 149 (1977); *King County Ins. Assoc. v. Commissioner*, 37 B.T.A. 288 (1932).

However, there are three significant limitations on the payment of rebates by exempt organizations that made reliance on this exception by NASD impossible. First, the refunds can only be paid from dues paid by the members receiving the refund. *See* Rev. Rul. 81-60, 1981-1 C.B. 335 (“Refunds ... must be made out of funds paid by those receiving the refunds.”). Second, a rebate, by definition, must not exceed the amount of dues previously paid by members. *See Michigan Mobile Home & Recreational Vehicle Inst. v. Commissioner*, 66 T.C. 770, 777 (1976) (revoking exemption where entity paid “rebates” that “were far in excess of the maximum annual dues”); Rev. Rul. 77-206 (“Rebates ... may not exceed the amount of the deposits.”). The Service has further required that only current-year dues can be rebated. *See, e.g.*, Rev. Rul. 81-60, *supra*. Third, the rebate must be made pro rata with respect to the dues previously paid, and must not reflect a preference for members. *Compare* Rev. Rul. 81-60, *supra* (pro-rata rebate permitted) *with Michigan Mobile Home, supra* (exemption revoked where fees for trade show were rebated to members but not to non-members).

Although the aggregate amount of the proposed Member Payments fits within the amount of allowable rebates, the rebate exception does not squarely apply here because a \$35,000 payment would far exceed the \$1,200 of current-year paid-in dues of those NASD members subject to the lowest annual assessments. Under the published rulings, a payment of \$35,000 could not be made to those small members without risking the loss of NASD’s tax exemption. It would be possible to structure the aggregate payment to the members so that it would fit within the rebate exception – but only if (i) the payments were made to members in proportion to total assessments, rather than in proportion to their base assessment, and (ii) the amount received by each member were limited to paid-in dues for the current year. If the Member Payments had been structured in that manner, members likely would have found the allocation unfair because small-firm members would receive a rebate in the range of \$1,200, but large-firm members would receive a much larger rebate.

Distributions upon Liquidation. Courts have allowed organizations exempt from tax under Section 501(c)(6) to make distributions to members on the event of the entity’s liquidation. *See, e.g., Washington State Apples v. Commissioner*, 46 B.T.A. 64, 70 (1942). NASD is not liquidating, and we have found no case or ruling that applied the liquidation exception to a transaction in which operations were to continue. In any event, it is likely that even upon liquidation, amounts distributed to members would be limited to previously paid-in dues, and that the entity’s exemption for the year of distribution would be revoked if members were to share in the earnings of the organization. *See Washington State Apples, supra*. While one Tax Court case has allowed

distribution of more than the previously paid-in dues (*Mill Lane Club v. Commissioner*, 23 T.C. 433 (1954)), the Seventh Circuit has also ruled that the mere fact that an exempt entity's charter allowed for distribution of assets to members upon liquidation was sufficient to invalidate its exemption where some of the assets had been purchased out of earnings, rather than dues (*Uniform Printing & Supply Co. v. Commissioner*, 33 F.2d 445 (7th Cir. 1929)).

Reasonable and Appropriate Expenses. The Tax Court has suggested on one occasion that the existence of inurement to members should be reviewed in light of "the reasonableness and appropriateness of the expenses" to the exempt purpose of the entity and that "control of financial decisions by individuals who appear to benefit personally from certain expenditures does not necessarily indicate inurement." *Unitary Mission Church*, 74 T.C. at 515. Although the Tax Court ultimately revoked the church's tax exemption, that dictum is consistent with the general proposition that an exempt organization can enter into arm's-length transactions with members. See Rev. Rul. 97-21, 1997-1 C.B. 121 (recruiting incentives negotiated at arm's length by tax-exempt hospital do not constitute private inurement); Rev. Rul. 80-106, 1980-1 C.B. 113 (consignment sales negotiated at arm's length by tax-exempt thrift shop do not constitute inurement); Priv. Ltr. Rul. 9643036 (arm's-length sale of substantially all the assets of tax-exempt hospital to a for-profit hospital did not result in private inurement).

Given the large size of the aggregate amount of the proposed Member Payment (\$170 million to \$180 million, depending on the number of members) in relation to the balance sheet of NASD, the IRS was unlikely to rule that the payment qualified as a reasonable and appropriate expense, even if it was necessary to the Proposed Transaction.

Determination of Amount of Member Payment. On an aggregate basis, the proposed Member Payment is within the amount that could be rebated in a manner consistent with the rebate exception. Moreover, given its size, the proposed Member Payment was supported economically by the present value of the expected incremental future cash flows attributable to the Proposed Transaction after taking into account transaction costs, including future rebates and other reductions in fees that were described in the Proxy Statement. Thus, it can be said that the proposed Member Payment would not reduce the value of NASD's equity.

IRS Ruling. The IRS has issued rulings (one each to NASD and NASDR) that the Proposed Transaction, which includes the proposed Member Payment, would not affect the tax-exempt status of NASD or NASDR. In the rulings, the IRS found that the Proposed Transaction would further the exempt purpose of NASD by producing benefits for the securities industry, and, by extension, for the public that relies on NASD and NASDR to ensure fairness in the industry. Because of (i) the importance of the payment to the Proposed Transaction as a

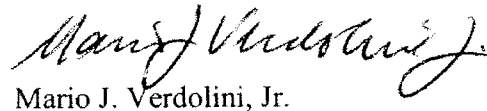
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whole; (ii) the financial data presented by NASD explaining that the amount of the Member Payment is expected to be paid out of the value of expected incremental future cash flows, rather than the value of NASD's equity; and (iii) the unique facts and circumstances of the Proposed Transaction, the IRS approved the Proposed Transaction, including the payment.

Under these circumstances, and based on the authorities and guidance described above, if NASD had increased the amount of the proposed Member Payment, there would have been a serious risk that the IRS would not have issued the rulings and that NASD could be found to violate the prohibition against private inurement if it went forward with the proposed Member Payment without the benefit of a ruling.

If you have any questions or if I can be of any further assistance, please do not hesitate to call me at (212) 450-4969.

Very truly yours,

A handwritten signature in black ink, appearing to read "Mario J. Verdolini, Jr.", written in a cursive style.

Mario J. Verdolini, Jr.