

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42983; File No. SR-NASD-00-27]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Amending the Nasdaq By-Laws and Restated Certificate of Incorporation

June 26, 2000.

I. Introduction

On May 11, 2000, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary The Nasdaq Stock Market, Inc. ("Nasdaq") filed with the Securities and Exchange Commission ("SEC" or "Commission") pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change amending the Nasdaq By-laws and Restated Certificate of Incorporation. The proposed rule change was published for comment in the **Federal Register** on May 23, 2000.³ The Commission received no comments on the proposal. This order approves the proposal.

II. Description of Proposal

The purpose of the proposed rule change was to amend Nasdaq's By-Laws and Restated Certificate of Incorporation ("Certificate") in accordance with the Restructuring Plan (the "Restructuring") approved by NASD members on April 14, 2000. The Restructuring involves broadening the ownership in Nasdaq (which is currently 100 percent owned by the NASD) through a two-phase private placement of common stock and warrants to NASD members, Nasdaq issuers, institutional investors and strategic partners. Nasdaq's By-laws and Certificate must be amended in order to reflect the changes to Nasdaq's ownership structure. Therefore, the proposed rule change included the amendments necessary to implement Phase I of the Restructuring.

Eventually, Nasdaq will submit an Application For, and Amendments to Application For, Registration as a National Securities Exchange or Exemption from Registration Pursuant to Section 5 of the Exchange Act to obtain exchange registration. Prior to its registration as a national securities exchange, however, Nasdaq will

continue to operate under the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries (the "Delegation Plan"), as approved by the Commission. After exchange registration, Nasdaq will no longer be governed pursuant to the Delegation Plan.

This Order does not address provisions of the existing Nasdaq By-laws Certificate and that remain unchanged, and it limits the discussion to the most significant changes to the corporate documents.

Summary of Significant Amendments

1. Authorized Capital Stock

To carry out the recapitalization of Nasdaq, the total number of shares that Nasdaq is authorized to issue has been increased to 330,000,000, consisting of 30,000,000 shares of preferred stock, par value \$.01 per share, and 300,000,000 shares of common stock, par value \$0.01 per share. In addition, the Nasdaq Board of Directors ("the Board") is now entitled to issue preferred stock in one or more series, and to fix the powers, preferences, rights, qualifications, limitations, and restrictions of this preferred stock (including, for example, dividend rights, conversion rights, voting rights, terms of redemption, liquidation preferences, etc). The issuance of preferred stock could have the effect of decreasing the market price of the common stock and could adversely affect the voting and other rights of the holders of common stock.

2. Scaled Voting Provision

The Certificate provides that holders of common stock are entitled to one vote per share on all appropriate matters, except that any person, other than the NASD or any other person approved by the Board prior to the time such person owns more than 5% of the then outstanding shares of common stock will be unable to exercise voting rights in respect of any shares owned in excess of 5%.⁴ Exemptions from this scaled voting provision can be granted by the Board. The Certificate, however, provides that in no event shall an exemption from the scaled voting provision be granted to (1) a registered broker or dealer, or an affiliate⁵ thereof,

⁴ This restriction on voting shares owned in excess of 5% is referred to as the "scaled voting provision."

⁵ The Certificate provides that an affiliate "shall not be deemed to include an entity that either owns ten percent or less of the equity of a broker or dealer, or the broker or dealer accounts for one percent or less of the gross revenues received by the consolidated entity." For purposes of this order, references to a broker or dealer will include affiliates, as defined in the By-laws or Certificate.

or (2) an individual or entity subject to statutory disqualification under Section 3(a)(39) of the Act. The Board may approve an exemption from the scaled voting provision if the Board determines that granting the exemption would (1) not reasonably be expected to diminish the quality of, or public confidence in, the Nasdaq Stock Market or other operations of Nasdaq, on the ability to prevent fraudulent and manipulative acts and practices and on investors and the public, and (2) promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities or assist in the removal of impediments to or perfection of the mechanisms for a free and open market and a national market system.

3. Board of Directors

The Certificate provides for a "classified" or "staggered" Board; that is, the Board will be divided into three classes, with one class to be elected each year to serve a three-year term. The By-laws also create a Chief Executive Officer ("CEO"), who shall have general supervision over the business and affairs of Nasdaq. The By-laws preserve the existing Industry, Non-Industry and Public classifications for Board Directors, and provide that the newly created CEO and President are deemed "neutral" directors for classification purposes.

The Certificate provides that the exact number of directors is to be determined by the Board from time to time. The By-laws require that the number of Non-Industry Directors, including at least one Public Director and at least one issuer representative, must equal or exceed the number of Industry Directors, plus the President and CEO (if they are elected Directors), unless the Board consists of 10 or more Directors. If the Board consists of 10 or more Directors, then at least two Directors shall be issuer representatives. The By-laws provide that at least two Industry Directors and two Non-Industry Directors shall be drawn from candidates proposed to the National Nominating Committee by a majority of the non-NASD stockholders of Nasdaq.⁶

⁶ As previously noted, Nasdaq currently operates under the Delegation Plan which authorizes NASD to elect the Board. Vacancies on the Board are filled by candidates put forward by the NASD's National Nominating Committee ("NNC"). The Board is currently authorized to consist of 10 members. Prior to Exchange registration, it is contemplated that the Board will be increased from 10 voting members to 14. These four new members of the Board will not be current members of the NASD Board of Directors, nor will they be able to serve

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 42790 (May 16, 2000), 65 FR 33384.

The By-laws also authorize the Nasdaq Board, rather than the NASD Board, to fill vacancies on the Nasdaq Board.

Under the Delegation Plan, all stockholders have the right to recommend one or more candidates for consideration by the NNC for nomination to the Board by providing written notice to the Corporate Secretary, containing specified information relating to the candidate (the candidate's name, industry classification, etc.).⁷

4. Removal of Directors and Committee Members

Directors previously could be removed with or without cause. The By-laws and Certificate now provide that Directors may only be removed for cause by an affirmative vote of a supermajority of outstanding shares entitled to vote. Removal of committee members still requires a majority vote of the Board and notice to the committee member, but the provision that committee members may only be removed for refusal, failure, neglect, or inability to discharge the committee member's duties is eliminated.

5. Annual and Special Meetings of Stockholders, and Stockholder Action

Because there will be multiple owners of Nasdaq, the By-laws now provide detailed procedures for the calling and conduct of annual and special meetings of shareholders. The Certificate provides that stockholders are not entitled to act by written consent in lieu of a meeting.

6. Notice Requirements for Stockholder Proposals and Stockholder Nominated Directors

The By-laws allow stockholders to bring business before an annual and special meeting of stockholders, and to nominate candidates for election as directors at an annual meeting of stockholders, provided they comply with the procedures outlined in the By-laws.

7. Amendments to the By-Laws

The By-laws and Certificate state that By-law amendments may be made by a supermajority vote of the shareholders or by the Board. In addition, the Certificate requires a supermajority vote

concurrently on the NASD Board of Directors. Two of the four new directors will be Industry Directors and the other two will be Non-Industry or Public Directors. Before exchange registration, or until such time that Nasdaq does not otherwise operate under the Delegation Plan, the Board is expected to consist of 14 members, the majority of whom shall be Public or Non-Industry Directors.

⁷ If Nasdaq as a national securities exchange, then the procedures for nomination to the Board may differ.

of the outstanding shares of common stock to amend, repeal or adopt certain provisions of the Certificate including, but not limited to, limitations on voting rights of certain persons, the classified Board, removal of Directors, and prohibitions on stockholder action by written consent.

8. Certificate, Article Eleventh—"Constituency Provision" Relating to Certain Corporate Transactions

A new provision, Article Eleventh of the Certificate, sets forth factors that the Board must consider when evaluating the merits of certain major corporate transactions such as tender or exchange offers, mergers, liquidations, any action relating to the voting cap, or other issues, due to the unique nature of Nasdaq and its operations and status as a self-regulatory organization.⁸ Article Eleventh requires that the Board shall to the fullest extent permitted by applicable law, take into account the following factors when evaluating a major corporate transaction: (1) The potential impact on the integrity, continuity and stability of The Nasdaq Stock Market and the other operations of Nasdaq, on the ability to prevent fraudulent and manipulative acts and practices and on investors and the public, and (2) whether such a transaction would promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, or assist in the removal of impediments to, or perfection of the mechanisms for, a free and open market and a national market system.

9. Other Changes to Conform the By-Laws and Certificate to Nasdaq's New Corporate Form

Other changes to the By-laws and Certificate are made to reflect Nasdaq's new ownership structure and to institute procedures necessary for Nasdaq to operate as a corporation. For example, references to "shareholder" have been changed to "shareholders," to reflect the fact that the NASD no longer owns 100% of Nasdaq and that ownership of Nasdaq will now be broadened to a number of entities and individuals. Similarly, provisions have been added relating to waiver of notice of a meeting by a Director, definitions of new terms (e.g., "beneficial owner" and "subsidiary"), and a provision defining

⁸ The Commission notes that, by its terms, Article Eleventh is not operative until the Commission approves nasdaq's registration as a national securities exchange.

the necessary quorum to approve interested party transactions.

III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association. The proposed rule change also fulfills the division of responsibilities as set forth in the Delegation Plan approved by the Commission. Pursuant to the Delegation Plan, NASD has retained the authority "[t]o exercise overall responsibility for ensuring that the Association's statutory and self-regulatory obligations are fulfilled."⁹ However, NASD has delegated to Nasdaq the responsibility to operate The Nasdaq Stock Market, including the responsibility to "develop and adopt rules, interpretations, policies, and procedures and provide exemptions to maintain and enhance the integrity, fairness, efficiency, and competitiveness of The Nasdaq Stock Market and other markets operated by The Nasdaq Stock Market."¹⁰ Thus, the Commission looks to NASD as the self-regulatory organization with statutory responsibility to implement and enforce the requirements of the Act, but Nasdaq, as a market owned and controlled by NASD, is required to operate The Nasdaq Stock Market and to provide rules, interpretations, policies, and procedures to carry out the purposes of the Act.¹¹ In the Discussion section below, the Commission applies this "chain" of regulatory responsibilities in its analysis and findings in support of this approval order.¹²

In light of the above, the Commission believes that the proposed rule change is consistent with the requirements of Section 15A(b)(2), (4) and (6)¹³ of the Act. Section 15A(b)(2)¹⁴ requires that the association be so organized and have the capacity to be able to carry out the purpose of the title and to comply, and to enforce compliance by its members and persons associated with its members, with the provisions of the

⁹ Section I(B)(1) of the Delegation Plan.

¹⁰ Section III(A)(1)(e) of the Delegation Plan.

¹¹ NASD, however, is ultimately responsible for ensuring that the Nasdaq's actions fulfill the statutory and self-regulatory obligations as set forth in the Act.

¹² The Commission also notes that the amendments to the By-laws and Certificate begin the process of implementing the corporate governance changes that will be necessary if Nasdaq registers as a national securities exchange.

¹³ 15 U.S.C. 78o-3(b)(2), (4) and (6).

¹⁴ 15 U.S.C. 78o-3(b)(2).

Act.¹⁵ Section 15A(b)(4)¹⁶ requires that the rules of an association 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 the association, broker, or dealer.¹⁷ Section 15A(b)(6)¹⁸ requires, among other things, that the association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and national market system, and, in general, to protect investors and the public interest.¹⁹

A. Amendments Incident to the Restructuring and Recapitalization of Nasdaq

The Commission finds that the amendments to Nasdaq's By-laws and Certificate authorizing certain corporate actions and implementing procedures that are necessary to allow Nasdaq to function as a for-profit corporation are consistent with Section 15A(b)(2)²⁰ of the Act. The Commission believes that the amendments relating to the following subject matters, as described in more detail above, are needed to reflect the recapitalization and restructuring of Nasdaq: the issuance of capital stock (both common and preferred shares); the procedures for calling and conducting annual meetings and special meetings of stockholders; the nomination and election procedures for the Board of Directors; the quorum calculations for interested party transactions; the defined terms; and the procedures for amendments to the By-laws and Certificate. These changes satisfy the requirements set forth in Section 15A(b)(2) that NASD be so organized and have the capacity to carry out the purposes of the Act.

B. Structure and Governance of Nasdaq's Board

Section 15A(b)(4)²¹ of the Act requires fair representation of an association's members in the selection of its directors and administration of its affairs, and provides that one or more directors shall be representative of

issuers and investors and not be associated with a member of the association, broker, or dealer. The NASD, through the Delegation Plan, has the responsibility for ensuring that the Nasdaq Board fulfills the fair representation and public participation requirements.²² The Commission finds that the proposed structure and composition of the Board fulfills the provisions of Section 15A(b)(4).

The fair representation requirement of Section 15A(b)(4) helps to ensure that no particular constituency is subject to the unfair, unfettered actions of another constituency, and helps to ensure that the NASD, including its Nasdaq subsidiary, is administered in a way that is equitable to NASD members.

In addition, to ensure that the public interest is adequately represented in an association's decision-making process, Section 15A(b)(4) states that an association must provide that one or more of its directors be representatives of issuers and investors. The Commission believes that public directors provide a unique, unbiased perspective that should enhance the ability of a board to address issues in a non-discriminatory fashion.

The Commission finds that the proposed composition of the Board meets the fair representation and public participation criteria as set forth in Section 15A(b)(4) of the Act. The By-laws provide that the number of Non-Industry Directors on the Board, including at least one Public Director and at least one issuer representative, shall equal or exceed the number of Industry Directors, plus the President and CEO (if they are elected Directors), unless the Board consists of 10 or more Directors. If the Board consists of 10 or more Directors, at least two Directors shall be issuer representatives. The Certificate also requires public participation on the Board. This structure ensures that all interests, Industry and Non-Industry, will be adequately represented on the Board. Further, the requirement that the number of Non-Industry Directors equal or exceed the number of Industry Directors, and the requirement of Public Directors helps to ensure that decisions by the Board are not unfairly discriminatory between customers, issuers, brokers, or dealers, and that the protection of investors and the public interest is considered. Therefore, the Commission believes that the Board structure is consistent with the fair representation and public participation

requirements of Section 15A(b)(4) of the Act.

C. Scaled Voting, Exemptions From Scaled Voting, and Other Limitations on the Control of Nasdaq

The Commission is concerned that the NASD's self-regulatory obligations may be challenged if a substantial portion of Nasdaq is owned or controlled by a broker or dealer that also trades on Nasdaq. In such a situation, it may be difficult for NASD to carry out its self-regulatory responsibilities if it is required to take action against that broker or dealer. These concerns will be heightened if NASD goes through with its plans to register Nasdaq as a national securities exchange, and sell off additional shares of Nasdaq to investors.

The scaled voting provision is one way of limiting the ability of any entity, particularly a registered broker or dealer, from controlling Nasdaq. However, permitting the Board to lift the voting cap in some cases is necessary to allow Nasdaq flexibility should Nasdaq seek to enter into a business combination in which it would want to use shares of common stock in the transaction. The Certificate therefore provides that the Board may generally lift the voting cap, but that it cannot be lifted for a broker or dealer (or an affiliate of a broker or dealer)²³ or any other individual or entity subject to statutory disqualification as defined in Section 3(a)(39) of the Act. The Board is also required to consider certain factors before lifting the voting cap for any other individual or entity.

The Commission believes that the proposed rule change relating to scaled voting, exemptions from scaled voting, and other limitations affecting the control of Nasdaq fulfill the obligations under Section 15A(b)(2) and (6). The Certificate provides for an absolute bar on a broker, dealer, or statutorily disqualified person, from voting shares owned in excess of 5%. Section 15A(b)(6) requires that rules be in place that prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, facilitate transactions in securities, and remove impediments to and perfect the mechanism of a free and open market and a national market system. The limitation on voting shares owned in excess of 5% satisfies this requirement because it helps to avoid a situation where the integrity of Nasdaq might be compromised if the NASD had to choose between taking action against a broker or dealer that owned, and could vote, a Nasdaq share in excess of 5%,

¹⁵ Again, through the operation of the Delegation Plan, NASD must be responsible for, and Nasdaq must implement, rules, policies and procedures that are consistent with the Act.

¹⁶ 15 U.S.C. 78o-3(b)(4).

¹⁷ See *supra* note 15.

¹⁸ 15 U.S.C. 78o-3(b)(6).

¹⁹ See *supra* note 15.

²⁰ 15 U.S.C. 78o-3(b)(2).

²¹ 15 U.S.C. 78o-3(b)(4).

²² The Delegation Plan also provides that the NASD will appoint Nasdaq's Board. Section I(B)(3) of the Delegation Plan.

²³ See *supra* note 5.

and fulfilling its self-regulatory responsibilities.

The Commission also finds that the current requirement that the Board consider factors relating to the qualifications of any shareholder (other than a broker or dealer or statutorily disqualified person) before lifting the voting cap also helps to address the Commission's concern that Nasdaq not be controlled or substantially influenced by an entity that may promote acts or practices that would be inimical to the purposes of the Act.

Two other provisions also act as a deterrent to a shareholder's ability to effect a rapid change in control of Nasdaq. The classified Board structure ensures that it will take at least two shareholder meetings, instead of one, for majority control of the board to shift. As discussed previously, the Certificate also provides that Directors may only be removed for cause and by a supermajority vote of the shareholders. These provisions, together with the scaled voting provision, help to ensure that control of Nasdaq will be attained only in a measured manner and consistent with the requirements set forth in the Act.

Finally, the Commission notes that as currently stated, a person or entity could own a substantial portion of Nasdaq and yet be limited in its actual control of Nasdaq by virtue of the scaled voting provisions, the classified Board structure, and the limitations on the removal of Directors in the By-laws and Certificate. While these provisions help ameliorate the Commission's concern about the control of Nasdaq, concerns about the ability of an entity—in particular a broker, dealer or affiliate—to own up to 100 percent of Nasdaq remain. Thus, further action to address the ownership of a substantial portion of Nasdaq by a broker, dealer or affiliate may be warranted if Nasdaq registers as a national securities exchange.

D. Certificate, Article Eleventh ("Constituency Provision")

By its own terms Article Eleventh applies when Nasdaq achieves "status as a self-regulatory organization," and it therefore will become operative only if the Commission approves Nasdaq's anticipated application to register as a national securities exchange. The Commission notes preliminarily, however, that Article Eleventh balances the need to ensure that Nasdaq fulfill the self-regulatory obligations incumbent upon it if it registers as a national securities exchange without unduly hampering Nasdaq's ability to consummate major corporate

transactions. Therefore, the Commission finds that new Article Eleventh of the Certificate is consistent with Section 15A(b)(6) of the Act and outlines a legitimate and useful set of criteria that should be considered by the Board if it considers major corporate transactions after exchange registration.

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²⁴ that the proposed rule change (SR-NASD-00-27) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁵

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 00-16745 Filed 6-30-00; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42984; File No. SR-NASD-00-35]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to a Cap on ACT Risk Management Charges

June 27, 2000.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on June 12, 2000, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II and III below, which Items have been prepared by Nasdaq. Nasdaq filed the proposal pursuant to Section 19(b)(3)(A) of the Act,³ and Rule 19b-4(f)(6) thereunder,⁴ which renders the proposal effective upon filing with the Commission.⁵ The Commission is publishing this notice to solicit

²⁴ 15 U.S.C. 78s(b)(2).

²⁵ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(6).

⁵ Nasdaq provided written notice to the Commission on June 8, 2000, that is intended to file this proposal. The Commission agreed to waive the 5-day pre-filing notice requirement. See Rule 19b-4(f)(6)(iii). 17 CFR 240.19b-4(f)(6)(iii).

comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

Nasdaq filed the proposed rule change to amend NASD Rule 7010, Systems Services, to establish a cap on the Automation Confirmation Transaction Service ("ACT") risk management charge. Nasdaq has designated this proposal as non-controversial, and requests that the Commission waive the 30-day pre-operative waiting period contained in Rule 19b-4(f)(6)(iii) under the Act,⁶ to allow the proposal to be both effective and operative immediately upon filing with the Commission. The text of the proposed rule is below. Proposed new language is in italics.

* * * * *

Rule 7010. Systems Services

(g) Automated Confirmation Transaction Service

The following charges shall be paid by the participant for use of the Automated Confirmation Transaction Service (ACT):

Transaction Related Charges:
No change.

Risk Management Charges: \$0.035/side and \$17.25/month per correspondent firm (*maximum \$10,000/month per correspondent firm*)

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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, Nasdaq included statements concerning the purpose of and basis for its proposal and discussed any comments it received regarding the proposal. The text of these statements may be examined at the places specified in Item IV below. Nasdaq 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

ACT is an automated trade reporting and reconciliation service that speeds the post-execution steps of price and volume reporting, comparison, and clearing of pre-negotiated trades completed in Nasdaq, OTC Bulletin

⁶ 17 CFR 240.19b-4(f)(6)(iii).