

November 27, 2002

Ms. 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-2002-99 - Proposed Rule Change to By-Laws Regarding Gross Income Assessments and Personnel Fee; Replacement of Response to Comments and Amendment No. 2

Dear Ms. England:

NASD hereby responds to the comment letters received by the Securities and Exchange Commission (“Commission” or “SEC”) in response to the publication in the Federal Register of Notice of Filing of SR-NASD-2002-99, regarding proposed changes relating to NASD’s member regulatory pricing structure.¹ In addition, in response to the comment letters and other considerations, NASD is submitting Amendment No. 2 to the rule proposal.

I. Background

On July 24, 2002, NASD filed with the SEC a proposed rule change to Schedule A to NASD By-Laws to amend its member regulatory pricing structure. Under the structure in place at the time, three types of fees and assessments were used to fund NASD’s member regulatory activities: Regulatory Fee,² Personnel Assessment, and Gross Income Assessment (“GIA”).³

¹ Exchange Act Release No. 46417 (Aug. 23, 2002), 67 FR 55893 (Aug. 30, 2002).

² The Regulatory Fee was described in Section 8(a) of Schedule A to NASD By-Laws.

³ The Personnel Assessment and Gross Income Assessment are described in Section 1 of Schedule A to NASD By-

The restructuring, as proposed, has four components: (1) elimination of the Regulatory Fee; (2) institution of a new transaction-based Trading Activity Fee (“TAF”) similar to the SEC’s Section 31 Fee; (3) an increase to the rates assessed to member firms under the Personnel Assessment; and (4) implementation of a simplified three-tiered flat rate for the GIA and elimination of the current deductions and exclusions.⁴ SR-NASD-2002-99 was a part of a package of two separate yet related rule filings⁵ submitted to the SEC to address the last two components of NASD’s pricing restructuring, by increasing the rates assessed to member firms under the Personnel Assessment and implementing the simplified three-tiered flat rate for the GIA and eliminating current deductions and exclusions.

The SEC published the two proposed rule changes for comment on August 30, 2002 and received a total of 15 comment letters, including submissions from market participants, national securities exchanges, and trade associations.⁶ This response to comments focuses on comments

Laws.

⁴ The changes resulting from the proposed restructuring would be revenue neutral.

⁵ The other rule filing was a proposed rule change that was filed under 19(b)(3)(A) of the Act to eliminate the Regulatory Fee and implement the TAF and to adjust the placement of the SEC Section 31 Transaction Fee in Schedule A (SR-NASD-2002-98). NASD subsequently filed two proposed rule changes with the SEC relating to SR-NASD-2002-98. The first (SR-NASD-2002-147) established a sunset provision that terminates on December 31, 2002 the changes made to Schedule A to the NASD By-Laws by SR-NASD-2002-98. The second rule filing (SR-NASD-2002-148) contained substantially the same rule language as proposed in SR-NASD-2002-98, but was submitted pursuant to 19(b)(1) of the Act to allow for an additional notice and comment period.

⁶ Letter from Philadelphia Stock Exchange dated Sept. 17, 2002 (“PHLX”); Letter from Securities Industry Association dated Sept. 26, 2002 (“SIA”); Letter from New York Stock Exchange dated Aug. 19, 2002 (“NYSE”); Letter from Commodity Futures Trading Commission dated Sept. 20, 2002 (“CFTC”); Letter from Chicago Mercantile Exchange, Inc., Board of Trade of the City of Chicago, Inc., and New York Mercantile Exchange, Inc. dated Sept. 20, 2002 (“Mercantile group”); Letter from Chicago Board Options Exchange dated Sept. 18, 2002 (“CBOE”); Letter from National Futures Association dated Sept. 19, 2002 (“NFA”); Letter from Fimat USA, Inc. dated Sept. 19, 2002 (“Fimat USA”); Letter from Goldenberg, Hehmeyer & Co. dated Sept. 23, 2002 (“Goldenberg”); Letter from Futures Industry Association dated Sept. 20, 2002 (“FIA”); Letter from TransMarket Group LLC dated Sept. 20, 2002 (“TransMarket Group”); Letter from Man Financial, Inc. dated Sept. 23, 2002 (“Man Financial”); Letter from Lehman Brothers dated Sept. 26, 2002 (“Lehman”); Letter from the Cincinnati Stock Exchange dated Sept. 27, 2002 (“CSE”); and Letter from CBOE, The Options Clearing Corporation (“OCC”),

made in connection with NASD's GIA and Personnel Assessment proposal (SR-NASD-2002-99) and does not address comments raised in connection with the TAF. NASD will address comments relating to the TAF separately.

A summary and analysis of the specific comments by issue is provided below. All of the comment letters discussed below addressed the GIA proposal; there were no comments received on the Personnel Assessment.⁷ The commenters that opposed the GIA proposal asserted that the GIA: (1) is anti-competitive, unfair and inequitable; (2) is inconsistent with SEC precedent; and (3) has no nexus to NASD regulatory services. After reviewing the comment letters, NASD is submitting Amendment No. 2 to the rule proposal to exclude commodities income from Gross Revenue for GIA purposes. The revised text of the rule proposal is attached as Exhibit 1 and incorporates the amendments described herein.

II. Response to Comments

A. Proposed Fees Allegedly Are Anti-Competitive, Unfair, and Inequitable

Six commenters argued that the proposed GIA is anti-competitive.⁸ Of these six commenters, four explained why they believe the GIA would raise anti-competitive concerns.⁹ The National Futures Association ("NFA") asserted that the GIA is anti-competitive because it favors Nasdaq. NFA stated that the GIA makes it more expensive to do business in other

International Securities Exchange, Inc. ("ISE"), the Pacific Exchange, Inc. ("Pacific"), and PHLX dated Sept. 23, 2002.

⁷ While no comments specifically focused on the Personnel Assessment, several commenters questioned whether the pricing structure as a whole, including the increase of the personnel assessment, is revenue neutral.

⁸ NYSE, PHLX, NFA, Man Financial, Mercantile group, and Fimat USA.

⁹ NFA, Man Financial, Mercantile group, and Fimat USA. NYSE states that the "fees" are anti-competitive but, other than asserting that the proposal appears not to be limited to recovery of costs, does not discuss why it believes the GIA is anti-competitive. PHLX notes "[t]he main infirmity of the Trading Activity Fee, and perhaps also the Gross Income Assessment (each as described in the filing), is that NASD would be charging its members who are also PHLX members ("NASD-PHLX members") for regulatory services in relation to transactions in "covered securities" (as defined in the filings) effected on the PHLX.

markets, including the futures markets, and therefore, the GIA should be “inherently suspect.”¹⁰

NFA also suggested that the GIA is unfair and inequitable because it has a disproportionate impact on firms engaging largely in commodities and non-securities related activities.¹¹

Similarly, Man Financial stated that the proposal would significantly raise the firm’s fees and, accordingly impose an anti-competitive burden on the firm. Man Financial also asserted that the GIA proposal requires firms that offer limited securities business to pay a disproportionate share of the regulatory expenses for firms that specialize in OTC securities, and that such fees will not provide “any corresponding benefit to those firms, to investors, or to the securities markets.” In addition, Fimat USA noted that the proposal would disproportionately affect firms registered as both broker/dealers and futures commission merchants (FCMs) by subjecting them to double taxation.

The anti-competitive concerns of these commenters are not well placed. NFA’s observation that the GIA places Nasdaq at a competitive advantage demonstrates a lack of understanding of the NASD-Nasdaq structure and the regulatory programs the GIA will fund. NASD uses funds collected through the GIA (and TAF and Personnel Assessment as well) solely to recover its costs of supervising and regulating NASD members’ activity in areas such as sales practice and suitability for which NASD has responsibility for members’ activity regardless of where such activity occurs. These revenues do not fund the regulation of Nasdaq or any other marketplace. Nasdaq will not receive any subsidization either directly or indirectly based on

¹⁰ In addition, NFA notes that the GIA could have an anti-competitive effect on NFA if NASD follows through on its announced intention to become a registered futures association because, if the GIA is in place, it would give the NASD an unfair advantage when competing for members as a registered futures association.

¹¹ This comment is also raised by CBOE, FIA, and Lehman.

these fees. All Nasdaq regulatory activities provided by NASD are, and will continue to be, fully funded by Nasdaq through its revenue structure.

NASD also disagrees with commenters that characterize these fees as unfair and inequitable. NASD believes that the proposed changes to the GIA will ensure that all NASD members use the same simplified fee structure and will be assessed on the same uniform basis. In addition, the proposed changes ensure that deductions and exclusions that were inconsistently used by member firms are no longer present. NASD notes that firms with gross income equal to or less than \$960,000 will continue to pay a flat fee of \$1,200. Because a member firm's GIA may increase does not mean that the fee is unfair or inequitable.

Although NASD strongly believes that the simplified GIA structure subject to no deductions and exclusions constitutes a reasonable fee that is equitably allocated, and consistent with the Act, NASD has determined to reinstate the exclusion for commodities income. NASD has observed that a number of its member firms conduct securities and commodities business in a single jointly registered entity, while others conduct a substantially similar business in separate entities with separate registrations under the securities laws and commodities laws. NASD has decided that to subject those conducting securities and commodities business in a single jointly registered entity to the increased expense burden (when the commodities income is already assessed under a comparable regulatory scheme) would result in similar entities receiving different treatment. Therefore, despite the fact that commodities income may in fact drive some regulatory costs for NASD for jointly registered firms, NASD will no longer assess commodities income for GIA purposes, as stated in Amendment No. 2.

B. Proposed Fees Are Allegedly Inconsistent with SEC Precedent for SRO Fees

Six commenters stated that the proposed rules are in violation of SEC's well-established policy relating to the imposition of regulatory fees, which requires that SRO fees be related to the regulatory responsibilities being funded.¹² The commenters cite the SEC approval of a broad Gross Income Assessment fee for the New York Stock Exchange (NYSE), which acknowledged the NYSE's role as designated examining authority ("DEA") when justifying the broad-based fee. NASD believes that the commenters' reading of the SEC's approval orders is overbroad and out of date. Central to the SEC analysis with respect to the NYSE regulatory fee was the distinction between those services that directly support that marketplace and those that have a universal nature, such as a FINOP exam. This distinction is inapplicable as to NASD. The costs to regulate member firms include funding for examinations, processing of membership applications, financial monitoring, policy, rule making, interpretive and enforcement activities. These NASD obligations are not appropriately identified as marketplace responsibilities. Unlike other self-regulatory organizations, NASD, as an Association, has regulatory responsibilities that are not tied to a single marketplace, instead they relate directly to our members.

Clearly, to be permissible under the Act, any SRO fee must be reasonable and equitably allocated. That does not mean that all broadly applied fees must recognize DEA versus non-DEA distinctions to pass statutory muster. In the current regulatory environment, the differences between the regulatory responsibilities of NASD when it is the DEA compared to when it is not the DEA are minimal. The financial and operational regulation that NASD allocates away to a member firm's DEA is a small percentage of its overall member regulatory responsibility toward that firm. Accordingly, the proposed fee structure recognizes the

¹² CFTC, Mercantile group, CBOE, FIA, NFA, and PHLX.

significant responsibilities that NASD undertakes irrespective of whether it is acting in a DEA capacity or a non-DEA capacity. For example, NASD regulatory responsibility in a non-DEA capacity extends to suitability, sales practice violations, customer complaints, membership modifications and applications, mutual fund activity, security futures activity, limited partnership activity, continuing education, registration and a host of other activities. These responsibilities extend to nearly 6,000 NASD members with different business models that effect a wide range of securities activities. And importantly, NASD's proposed member regulatory pricing structure is revenue neutral to NASD and is designed only to ensure recovery of its member regulatory costs.¹³

C. No Clear Nexus Allegedly Between Proposed Fees and NASD's Regulatory Services

Nine commenters stated that the proposed GIA would impose fees on transactions that have no regulatory nexus to NASD.¹⁴ The majority of these commenters objected to including commodities income as part of the GIA. One commenter believed that "NASD's proposed discarding of revenue exemptions and exclusions for non-securities activity amounts to nothing more than a penalty."¹⁵ Fimat USA and the Mercantile group were concerned that allowing NASD to collect these fees would set a precedent for other SROs to implement similar fees.

As stated above, NASD has determined to reinstate the exclusion for commodities income, although that decision was not based on a conclusion that NASD lacks a regulatory

¹³ Several commenters question whether the NASD's proposal is, in fact, revenue neutral. For example, NFA states "NASD claims that its entire proposal would be revenue neutral, but it does not provide any figures to support that claim." We note the SEC staff has been provided with a high level overview of costs and expected revenues under the revised pricing structure to support the NASD's statement that the proposal is revenue neutral.

¹⁴ CFTC, Mercantile group, CBOE, NFA, Fimat USA, Goldenburg, FIA, TransMarket Group, and Man Financial.

¹⁵ Goldenburg.

nexus to such activity, but on a determination to treat similarly situated firms comparably. All conduct, not just the purchase and sale of securities, within a registered broker-dealer drives some level of member regulatory effort for its SRO, whether it is financial surveillance, anti-fraud enforcement, supervision, or other requirements. Further, the statutory requirement that fees be reasonable and equitably allocated does not require a pricing structure so specific and complex as to tie specific self-regulatory programs and related expenses to specific business lines within a firm. As noted in the original filing, NASD believes that total revenues of a broker-dealer member, in combination with the trading activity of those members and the number of registered persons, serves as an effective proxy for what drives NASD's member regulatory costs.

With respect to concerns expressed by commenters that other markets may implement fees similar to NASD's fees, we reiterate that NASD's fees are directly related to the regulatory responsibilities of NASD, are member regulatory fees not market regulatory fees, and are revenue neutral to NASD. Each SRO is responsible for funding its regulatory program, regardless of whether members are dually registered.

D. Other Issues

SIA suggested that more time is needed to provide comments on the related TAF proposal and how it interrelates with the GIA and Personnel Assessment, as well as the regulatory fees of other SROs. Until the TAF rate is established, the SIA noted, it would be difficult to determine the implications of the TAF, separate and in combination with the GIA and Personnel Assessment.

NASD has established the TAF rates and published the most recent rates in Notice to Members 02-75. Accordingly, NASD members can fully assess the impact of the TAF in

combination with the GIA and Personnel Assessment. Furthermore, the TAF (as filed in SR-NASD-2002-148) is now subject to a full notice and comment period, so members will have the ability to submit another comment letter in connection with the TAF proposal.

III. Amendments to the Rule Filing

NASD believes that the foregoing fully responds to material issues raised by the commenters. In response to certain comments identified above, and upon further consideration of the rule proposal, NASD hereby amends the rule filing as follows (deleted text from the proposal is bracketed; new text is underlined):

* * * * *

Schedule A to NASD By-Laws

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Section 2 – Gross Revenue for Assessment Purposes

- (a) Gross revenue is defined for assessment purposes as total income as reported on FOCUS form Part II or IIA with the following exclusion: commodities income.

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B. Statutory Basis

The NASD believes that the proposed rule change is consistent with Section 15A(b)(5) of the Act,¹⁶ which requires, among other things, that NASD's rules provide for the equitable allocation of reasonable dues, fees, and other charges among members and issuers and other persons using any facility or system which NASD operates or controls. Moreover, the level of the fee is reasonable because it directly relates to the recovery of the costs of supervising and regulating members.

¹⁶ 15 U.S.C. 78o-3(b)(6).

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

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

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

Other than the comments responded to herein, written comments on the proposed rule change were not solicited or received.

If you have any questions, please contact Kathleen A. O'Mara, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8056. The fax number of the Office of General Counsel is (202) 728-8264.

Sincerely,

Barbara Z. Sweeney
Senior Vice President and Corporate Secretary