

Notice to Members

DECEMBER 2006

SUGGESTED ROUTING

Finance
Legal & Compliance
Registered Representatives
Senior Management
Trading

KEY TOPICS

NASDAQ Exchange Market Makers
Riskless Principal
Trading Activity Fee

GUIDANCE

Trading Activity Fee

Clarification of Exemption for Market Makers Acting in the Capacity of Exchange Market Maker and Interpretive Guidance Relating to Riskless Principal Transactions

Executive Summary

NASD is issuing this *Notice* to supplement guidance provided in *NASD Notice to Members (NTM) 06-44* relating to the application of the Trading Activity Fee (TAF) to members acting in the capacity of an exchange specialist or market maker.

In *NTM 06-44*, NASD stated that the exemption for proprietary transactions effected on the NASDAQ Exchange in the capacity of a market maker was limited to those transactions effected through a registered market maker's attributable quote. In response to members' concerns regarding the complexity of distinguishing between transactions resulting from attributable versus unattributable quotes, NASD is expanding the exemption for proprietary transactions effected on an exchange in the capacity of a market maker to include transactions effected through both attributable and unattributable orders/quotes.

This expansion of the market maker proprietary transaction exemption will be retroactively effective to August 1, 2006. Members that have already calculated and reported their TAF obligations under the previous guidance that do not wish to re-calculate and amend previously submitted TAF Self-Reporting Forms may begin applying the expanded exemption beginning December 1, 2006.

NASD is also providing in this *Notice* additional guidance regarding the application of the TAF with respect to riskless principal transactions.

Questions/Further Information

Questions concerning this *Notice* should be directed to the Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8071; or NASD Finance at (240) 386-5397.

Background and Discussion

In 2003, the SEC approved NASD's new member regulatory pricing structure, which: (1) eliminated the NASDAQ market-based regulatory fee; (2) instituted a new transaction-based TAF applied across a broader range of equity, options and securities futures transactions; (3) increased the rates assessed to member firms under the Personnel Assessment (PA); and (4) implemented a simplified three-tiered flat rate for the Gross Income Assessment (GIA), whereby deductions and exclusions were eliminated.¹ NASD uses fees collected under the member regulatory pricing structure to fund member regulatory activities, including the regulation of members through examination, processing of membership applications, financial monitoring, policymaking, rulemaking, and interpretive and enforcement activities.

Exemption for Market Makers Acting in the Capacity of Exchange Market Maker

Section 1 of Schedule A to NASD's By-Laws exempts from the TAF "proprietary transactions by a firm that is a member of both NASD and a national securities exchange, effected in its capacity as an exchange specialist or market maker, and that are subject to Securities Exchange Act of 1934, Section 11(a) and Rule 11a1-1(T)(a) thereunder." Accordingly, this exemption applies to transactions that occur on the NASDAQ Exchange in the same manner it is applicable to transactions that occur on other exchanges. To assist members in understanding the application of this exemption to market making activity on the NASDAQ Exchange, NASD published *NTM 06-44* and is now supplementing that guidance in this *Notice*.

Specifically, NASD has expanded the exemption to include all proprietary transactions effected in a member's capacity as a market maker on the NASDAQ Exchange (or any other exchange on which the member is a registered exchange market maker), regardless of whether the quote/order was initially entered on an attributable or unattributable basis. As stated in *NTM 06-44*, transactions not effected through the NASDAQ Exchange, such as those reported to either a Trade Reporting Facility (TRF)² or the Alternative Display Facility (ADF),³ will be subject to the TAF, regardless of whether the transaction was effected in the member's capacity as a market maker.

Riskless Principal Transactions

Since the implementation of the TAF in 2003, NASD has issued numerous *NTMs* containing interpretive guidance regarding how the TAF is to be applied in various trading scenarios, including the treatment of riskless principal transactions. In response to questions received by the staff with respect to riskless principal transactions, NASD is clarifying guidance with respect to the appropriate application of the TAF to such transactions. The following guidance applies to all riskless principal transactions regardless of whether the member is a market maker or non-market maker, or if the transaction is executed on a national securities exchange or over-the-counter.

As provided for in Question 14 of *NTM 02-63*, transactions that qualify for riskless principal treatment under applicable trade reporting rules will be viewed as one transaction for purposes of assessing the TAF.⁴ Assessment of the TAF for trades executed in a riskless principal capacity depends on whether your firm received the order from another NASD member broker-dealer, a customer⁵ or a non-NASD member broker-dealer. Specifically:

- Members executing sell orders in a riskless principal capacity on behalf of another NASD member will not be assessed a TAF, consistent with application of the TAF to transactions where one member acts as agent on behalf of another member (See Q3 of *NTM 02-75*). Rather, the TAF is assessed on the NASD member who is the ultimate seller of the security, not the firm acting as riskless principal.
- Members executing sell orders in a riskless principal capacity on behalf of a customer will be assessed the TAF, consistent with the application of the TAF to transactions where a member effects a sale for a customer on an agency basis (See Q2 of *NTM 02-75*).
- Members executing sell orders in a riskless principal capacity on behalf of a non-NASD member broker/dealer will be assessed a TAF only if the transaction occurs otherwise than on a national securities exchange. If the order is executed on a national securities exchange, no TAF will be assessed on the member acting in a riskless principal capacity.

Endnotes

- 1 See Exchange Act Release No. 47946 (May 30, 2003), 68 FR 34021 (June 6, 2003) (approving SR-NASD-2002-148) and Exchange Act Release No. 47106 (Dec. 30, 2002), 68 FR 819 (Jan. 7, 2003) (approving SR-NASD-2002-99).
- 2 See Exchange Act Release No. 54084 (June 30, 2006), 71 FR 38935 (July 10, 2006) (File No. SR-NASD-2005-087) (SEC approval of the changes to NASD rules to reflect NASDAQ's Exchange Registration and the operation of the TRF by NASDAQ subject to NASD's regulatory license and oversight).
- 3 See Exchange Act Release No. 46249 (July 24, 2002), 67 FR 49822 (July 31, 2002) (SEC approval of SR-NASD-2002-97 authorizing NASD to operate the ADF on a pilot basis); Exchange Act Release No. 47633 (Apr. 10, 2003), 68 FR 19043 (Apr. 17, 2003) (File No. SR-NASD-2003-067) (extension of ADF pilot until January 26, 2004); Exchange Act Release No. 49131 (Jan. 27, 2004), 69 FR 5229 (Feb. 3, 2004) (File No. SR-NASD-2004-012) (extension of ADF pilot until October 26, 2004); Exchange Act Release No. 50601 (Oct. 28, 2004), 69 FR 64611 (Nov. 5, 2004) (File No. SR-NASD-2004-160) (extension of ADF pilot until July 26, 2005); Exchange Act Release No. 52122 (July 25, 2005), 70 FR (Aug. 1, 2005) (File No. SR-NASD-2005-092) (extension of ADF pilot until April 26, 2006); and Exchange Act Release No. 53699 (April 21, 2006), 71 FR 25271 (Apr. 28, 2006) (File No. SR-NASD-2006-050) (extension of ADF pilot period until January 26, 2007).
- 4 Specifically, Q14 in *NTM 02-63* states: "Q. If a firm executes a trade on a riskless principal basis, will a fee be assessed on both the initial leg of the transaction and the offsetting transaction with the customer? A. No. Riskless principal transactions reported correctly will be viewed as one transaction for the purposes of assessing the Trading Activity Fee."
- 5 For purposes of these requirements, customer is defined as not a broker-dealer. See NASD Rule 0120(g).

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