

Barbara Z. Sweeney  
Senior Vice President and Corporate Secretary  
(202) 728-8062-Direct  
(202) 728-8075-Fax

May 19, 2004

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-2003-201 – Proposed Amendments to Schedule A of the NASD By-Laws to Adjust the Trading Activity Fee Rate and Add TRACE-Eligible and Municipal Securities as Covered Securities: Response to Comments and Amendment No. 1**

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-2003-201, regarding proposed changes to NASD’s member regulatory pricing structure.<sup>1</sup> Furthermore, in response to the comment letters, NASD is submitting Amendment No. 1 to the rule proposal. For your convenience, attached is a new Exhibit 1 that includes the text of the proposed amendments to the original filing.

I. Background

On July 24, 2002, NASD filed with the SEC proposed changes to the Gross Income Assessment (“GIA”), Personnel Assessment (“PA”),<sup>2</sup> and Regulatory Fee.<sup>3</sup> Those fees are used to fund NASD’s member regulatory activities, including the regulation of members through examinations, processing of membership applications, financial monitoring, policymaking, rulemaking, and enforcement activities. The changes to NASD’s member regulatory pricing structure: (1) eliminated the Regulatory

---

<sup>1</sup> Securities Exchange Act Rel. No. 49114 (Jan. 22, 2004), 69 FR 4194 (Jan. 28, 2004).

<sup>2</sup> Securities Exchange Act Rel. No. 46416 (Aug. 23, 2002), 67 FR 55901 (Aug. 30, 2002) (notice of filing for immediate effectiveness of SR-NASD-2002-98, the Trading Activity Fee (“TAF”) pilot program). NASD subsequently filed SR-NASD-2002-148 to subject the proposal in SR-NASD-2002-98 to a full notice and comment period and to adopt a permanent TAF program. See Securities Exchange Act Rel. No. 46817 (Nov. 12, 2002), 67 FR 69785 (Nov. 19, 2002).

<sup>3</sup> Securities Exchange Act Rel. No. 46417 (Aug. 23, 2002), 67 FR 55893 (Aug. 30, 2002) (SR-NASD-2002-99).

Fee; (2) instituted a new transaction-based Trading Activity Fee (“TAF”) applied across all markets, similar to the SEC’s Section 31 fee; (3) increased the rates assessed to member firms under the PA; and (4) implemented a simplified three-tiered flat rate for the GIA whereby deductions and exclusions were eliminated.

The new member regulatory pricing structure, as approved by the SEC,<sup>4</sup> is revenue neutral to NASD and designed to better align NASD’s regulatory fees with its functions, efforts, and costs. To ensure a member regulatory pricing structure that is revenue neutral to NASD, NASD committed to analyze rates, volumes, and regulatory responsibilities periodically to sustain adequate funding levels for its member regulatory programs.<sup>5</sup> Further, as part of a three-year phase-in plan included in the originally proposed pricing structure, NASD stated its intent to reduce the revenue contribution from the collection of the TAF by approximately 50% over the three-year period, offset by an increase in the PA. Finally, in response to comments from a number of members and other self-regulatory organizations (“SROs”) about the scope of the TAF, NASD committed to analyze whether debt transactions should be included.

With the current proposed rule change, NASD has proposed adjusting the rate for covered equity securities; reducing the maximum per trade charge on covered equity securities; and assessing the TAF on corporate debt securities that, under the Trade Reporting and Compliance Engine (“TRACE”) rules, are defined as “TRACE-eligible securities” and on municipal securities subject to the Municipal Securities Rulemaking Board (“MSRB”) reporting requirements. The SEC published the proposed rule change for comment in the Federal Register on January 28, 2004, and received fourteen comment letters on the proposal.<sup>6</sup> NASD responds to these comments below.

---

<sup>4</sup> Securities Exchange Act Rel. No. 47946 (May 30, 2003), 68 FR 34021 (June 6, 2003) (approving SR-NASD-2002-148) and Securities Exchange Act Rel. No. 47106 (Dec. 30, 2002), 68 FR 819 (Jan. 7, 2003) (approving SR-NASD-2002-99).

<sup>5</sup> NASD stated in the text of the TAF rule that it will “periodically review these revenues in conjunction with these costs to determine the applicable rate.” NASD By-Laws, Schedule A, Section 1(a).

<sup>6</sup> Letter from RW Smith & Associates dated February 11, 2004 (“RW Smith”); Letter from Chapdelaine Corporate Securities & Co. dated February 12, 2004 (“Chapdelaine Corporate”); Letter from Chapdelaine & Co. dated February 16, 2004 (“Chapdelaine”); Letter from Associated Bond Brokers, Inc. dated February 17, 2004 (“Associated Bond Brokers”); Letter from Bear, Stearns & Co., Inc. dated February 17, 2004 (“Bear, Stearns”); Letter from The Bond Market Association dated February 17, 2004 (“BMA”); Letter from Edward D. Jones & Co., LP dated February 17, 2004 (“Edward Jones”); Letter from Rafferty Capital Markets, LLC dated February 17, 2004 (“Rafferty”); Letter from Kirkpatrick, Pettis, Smith, Polian Inc. dated February 17, 2004 (“Kirkpatrick, Pettis”); Letter from The Security Traders Association of New York, Inc. dated February 18, 2004 (“STANY”); Letter from The MuniCenter dated February 18, 2004 (“MuniCenter”); Letter from UBS Securities LLC dated February 18, 2004 (“UBS”); Letter from the Security Traders Association dated February 19, 2004 (“STA”); and Letter from O. Gene Hurst, Esq. dated February 20, 2004 (“O. Gene Hurst”).

In addition, NASD is submitting Amendment No. 1 to the rule proposal. It is intended to clarify that the TAF is assessed on TRACE-eligible securities that also are “reportable TRACE transactions” and that “any reportable TRACE transactions” are not exempt under Schedule A to NASD By-Laws, Section 1(b)(2)(B). NASD hereby requests that the SEC find good cause pursuant to Section 19(b)(2) for approving this amendment on an accelerated basis. NASD notes that this proposal, in substantially the same form, was previously published in the Federal Register for notice and comment. Moreover, NASD would like to ensure the rate reduction for covered equity securities included in this proposal is implemented promptly.

## II. Response To Comments

### A. Proposal Lacks Sufficient Financial Information

Six commenters believe that the proposal does not contain sufficient information for the SEC to determine that it provides for the “equitable allocation of reasonable dues, fees, and other charges” as required by the Securities Exchange Act of 1934 (the “Act”).<sup>7</sup> These commenters believe that NASD should provide financial information in the rule filing to allow the SEC and commenters to evaluate the merits of the proposal, such as an accounting of revenue generated by the TAF and the regulatory costs associated with overseeing the debt markets. In addition, five commenters do not believe that there is a nexus between the TAF and the regulatory costs it seeks to fund.<sup>8</sup>

Following an earlier notice and comment period, the SEC previously approved NASD’s member regulatory pricing structure as being consistent with Section 15A(b)(5) of the Act, and thus “reasonable” and “equitably allocated” to recover NASD costs related to the regulation and oversight of its members.<sup>9</sup> Notably, in approving the TAF, the SEC urged NASD to implement the TAF “in all areas the NASD must oversee, to better allocate regulatory costs to these activities.”<sup>10</sup> This proposal extends NASD’s approved pricing structure to TRACE-eligible securities and municipal securities, areas over which NASD exercises primary examination and enforcement authority and responsibility. That authority provides the direct nexus to the areas proposed to be covered by the TAF, in accordance with the SEC’s suggested approach. Further, NASD need not specify costs and revenues on a product-by-product basis to demonstrate that the fee is consistent with Section 15A(b)(5) of the Act.

### B. Duplicate Assessments

---

<sup>7</sup> RW Smith; BMA; STANY; Chapdelaine Corporate; Rafferty; and The MuniCenter.

<sup>8</sup> RW Smith; BMA; STANY; Chapdelaine Corporate; and Rafferty.

<sup>9</sup> Securities Exchange Act Rel. No. 47946 (May 30, 2003), 68 FR 34021 (June 6, 2003) (approving SR-NASD-2002-148) and Securities Exchange Act Rel. No. 47106 (Dec. 30, 2002), 68 FR 819 (Jan. 7, 2003) (approving SR-NASD-2002-99).

<sup>10</sup> Id.

Nine commenters question whether the proposal constitutes double taxation and state that it fails to consider existing regulatory fees,<sup>11</sup> with a subset of those commenters stating that SRO fees should be coordinated across all SROs with overlapping jurisdiction.<sup>12</sup> Five commenters note that the MSRB (not NASD) provides rulemaking and policy functions for municipal securities and that the fees that the MSRB already charges should be used to fund all regulation.<sup>13</sup> Furthermore, four commenters assert that TRACE transaction fees already include a charge that was intended to recover costs incurred to oversee the corporate debt market, making the extension of the TAF to TRACE-eligible securities unnecessary.<sup>14</sup>

NASD believes that extending the TAF to corporate and municipal debt does not constitute a redundant assessment on top of either TRACE fees or MSRB fees. NASD is responsible for enforcing MSRB rules, which includes supervising and regulating its members' activities in municipal securities through examinations, financial monitoring, and, as appropriate, disciplinary actions. NASD does not receive any portion of the fees that the MSRB collects from its members, and must directly fund the attendant regulatory costs. Accordingly, the assessment of the TAF on municipal securities to recover NASD member regulatory costs is clearly consistent with the Act.

Furthermore, regulatory costs currently funded by the TRACE fee structure are not funded by any other fees or assessments of NASD. This will continue to be the case after the TAF is extended to corporate and municipal debt. Consequently, NASD will not charge duplicative member regulatory fees on TRACE-eligible securities. As represented in SR-NASD-2003-157, NASD will consider the overall financial effect on TRACE

---

<sup>11</sup> RW Smith; BMA; Kirkpatrick, Pettis; Chapdelaine; Chapdelaine Corporate; Rafferty; Bear, Stearns; The MuniCenter; and Edward Jones. In addition, several of these same commenters are concerned that increased fees will adversely affect secondary fixed income securities trading. Commenters generally state that assessing such fees when the costs to do business continue to increase (without any offsetting increase to revenues) is inappropriate. Specifically, some of these same commenters note regulatory costs have substantially increased due to significant increases in NASD's gross revenue assessment, NASD's personnel assessment, new TRACE fees, and expenses firms must pay to ensure compliance with these regulations. NASD has established a member regulatory pricing structure that is revenue neutral to NASD and that was approved by the SEC as reasonable and equitable. This fee structure aligns NASD's regulatory fees with its functions, efforts, and costs. While regulatory fees generally constitute additional cost for member firms, these costs are necessary, especially in a highly regulated industry such as the securities industry.

<sup>12</sup> RW Smith; BMA; and Bear, Stearns & Co.

<sup>13</sup> RW Smith; BMA; Chapdelaine; Edward Jones; and Kirkpatrick, Pettis. In addition, The MuniCenter notes that the numerous fees in the fixed income community are difficult to track and monitor, leading to greater amounts of time needed to ensure proper billing. The commenter asks that a more simple and equitable fee structure be devised.

<sup>14</sup> Edward Jones; RW Smith; BMA; and Bear, Stearns.

participants of any new NASD fees imposed on TRACE-eligible securities, such as the TAF.

C. TAF Is Assessed On Multiple Parties To A Transaction And Does Not Address Competitive Issues

Three commenters state that they are concerned that two different parties are paying the same fees on the same transactions.<sup>15</sup> Similarly, one commenter asserts that the proposal does not preclude the imposition of two charges on a transaction involving a sale by a customer to the firm followed by the sale to another customer from the firm's inventory.<sup>16</sup> Another commenter asserts that, as a result, transactions between dealers and non-dealers will require Alternative Trading Systems ("ATs") to pay two TAF fees.<sup>17</sup> This commenter asserts that ATs will have to pay double the costs of traditional "players."<sup>18</sup> In addition, three commenters believe that NASD has failed to address the competitive burdens on municipal securities dealers that compete with bank municipal securities dealers that are not NASD members and therefore not subject to the TAF.<sup>19</sup> Furthermore, two commenters note that, as intermediaries, they cannot pass these costs on to their broker-dealer customers because these customers are already paying fees on the same transactions.<sup>20</sup>

NASD recognizes that two TAF fees will be charged in certain circumstances. This is consistent with how the fees are charged on covered equity securities, and is reflective of the fact that interactions with customers are a primary driver of member regulatory costs. NASD devised the TAF as one component for recovering its member regulatory costs, with the focus of the TAF being a member firm's individual trading activity. If a member firm's business model is to regularly engage in transactions with customers, then the member will be assessed in accordance with this activity and in conformity with NASD's member regulatory costs. This policy is consistently applied to all members for transactions in covered securities.

With respect to potential disparities with fees imposed on bank municipal securities dealers that are not NASD members, NASD is not in a position to comment on the manner in which banking regulators assess their regulated institutions for the costs of oversight. NASD re-emphasizes, however, that the TAF serves to recover NASD's costs of member regulatory services in conformity with NASD's statutory obligations. NASD

---

<sup>15</sup> Chapdelaine; Chapdelaine Corporate; and Rafferty.

<sup>16</sup> Edward Jones.

<sup>17</sup> The MuniCenter.

<sup>18</sup> Id.

<sup>19</sup> RW Smith; BMA; and Chapdelaine.

<sup>20</sup> Chapdelaine and Chapdelaine Corporate.

has met its obligation to demonstrate that its fees are reasonable and fairly allocated among its members. Moreover, NASD has structured its member regulatory fee program, as approved by the SEC, in a manner that does not impose burdens on competition that are not necessary or appropriate in furtherance of the Act.

Lastly, with respect to intermediaries' assertions that they are not able to pass these costs onto their broker-dealer customers, the decision of whether to pass costs onto a firm's customers is a business decision that must be made by the individual firm. There is nothing inherent in these fees that calls for passing them onto a firm's customers.

#### D. Other SROs May Adopt Such Fees

Two commenters are concerned that other SROs may adopt similar fees on certain fixed income markets. They assert that the lack of supporting disclosure in the proposal may prompt other SROs to impose new fees or increase current fees without providing assurances that the fees are related to their regulatory costs.<sup>21</sup>

The proposed fees are directly related to NASD's responsibilities to oversee activities in the debt markets. In approving the original TAF filing, the SEC stated that it does not believe that an SRO can impose fees on transactions executed on markets for which the SRO either has little or no nexus to regulatory tasks performed by the SRO or for which the SRO has no business interest. Most SROs do not have the broad regulatory responsibilities that NASD has regarding members' activities with customers, and, in NASD's view, are unlikely to demonstrate a sufficient regulatory nexus to impose a transaction fee on fixed income securities transactions that do not occur in the SRO's market.

#### E. Proposed Fee Will Adversely Impact Certain Firms

Three commenters believe that the proposal will have a disparate impact on retail-oriented firms and investors because it effectively reduces the marginal costs of larger transactions.<sup>22</sup> One of these commenters further states that the application of one fee to all trades is possibly unfair to retail firms because the new cap would disadvantage firms whose business model is to engage in many "smaller" transactions, as opposed to those who engage in larger transactions on behalf of institutional clients.<sup>23</sup> Similarly, another

---

<sup>21</sup> RW Smith and BMA.

<sup>22</sup> RW Smith; BMA; and Edward Jones. These same commenters believe that the TAF should be assessed equitably on a sliding scale similar to that used to assess TRACE fees; however, the sliding scale TRACE fee, which is one of three different TRACE fee schedules, was appropriately established to recover developmental and operational costs from users of the TRACE system. The TAF, in contrast, is based on SEC Section 31 regulatory fees and is aimed at recovering NASD's broad based member regulatory costs. The TAF is an SEC-approved methodology and, when viewed in conjunction with the GIA and PA, serves as an effective proxy for what drives NASD member regulatory costs.

<sup>23</sup> Edward Jones.

commenter claims that, with the maximum fee of \$.75 per trade, the proposal appears to unfairly target smaller transactions.<sup>24</sup>

NASD recognizes that the imposition of the proposed fee cap generally would result in assessing a higher aggregate fee on certain retail activity, when occurring in numerous smaller trades, than would result if the same volume of activity were to occur in, for example, one institutional trade; however, retail trades generally drive member regulatory costs as much as, if not more than, institutional trades, and a higher number of trades results directly in higher member regulatory costs. Accordingly, NASD has proposed a cap consistent with its goal of assessing a reasonable fee that is fairly allocated among its membership and that is reflective of NASD's regulatory functions, efforts, and costs.

#### F. Proposal Does Not Provide Details Regarding Its Implementation

Three commenters believe that NASD should clarify whether, or to what extent, existing NASD guidance on the application of the TAF to equities would apply to covered debt securities.<sup>25</sup> For example, the commenters question how agency and riskless principal guidance currently applicable to equities would be applied to the TAF for debt. In addition, these commenters inquire whether the TAF will be charged on the buy side as is done for customer transactions in equities. These commenters assert that applying this interpretation to covered debt securities would result in a significantly greater number of trades in debt being subject to the TAF since broker-dealers engaging in debt activities more often trade as principal (instead of engaging in a contemporaneous sale as agent or acting in a riskless principal capacity, as is typical in equities). Consequently, the commenters believe that they will more often be charged for both the buy from the customer and the subsequent sell to a broker-dealer.

These same commenters also ask why NASD should charge the TAF on all TRACE-eligible securities without regard to whether the transactions at issue are subject to TRACE reporting. They claim this will cause significant operational and system issues in connection with trades that are not required to be reported, such as repo transactions. Accordingly, they suggest exempting from the TAF those transactions that are not reported to TRACE. These commenters also believe that NASD should identify any differences between the manner in which trades in covered securities are currently reported and the manner in which they would be required to be monitored and reported for the TAF. Lastly, the commenters question whether the effective date provides sufficient lead-time to make the requisite system/programming changes.

NASD will address interpretive issues with respect to the application of the TAF to debt securities in a Notice to Members, as it has done in the case of covered equity securities. NASD, in general, expects to apply the TAF to equity and debt securities in as consistent a manner as possible; however, if members can demonstrate that there are

---

<sup>24</sup> Associated Bond Brokers.

<sup>25</sup> RW Smith; BMA; and UBS.

specific scenarios for which the TAF should apply differently to debt than to equities, NASD will consider such information before issuing interpretive guidance with respect to debt.

In response to commenters' concerns that the TAF be assessed only on TRACE-eligible securities subject to TRACE reporting requirements, NASD has determined to amend its filing to clarify that the TAF will only be assessed on "TRACE-eligible securities" where the transaction also is a "reportable TRACE transaction," as those terms are defined in NASD Rule 6210. In addition, because debt securities that are issued pursuant to Section 4(2) of the Securities Act of 1933 and re-sold pursuant to Rule 144A in secondary market transactions are "reportable TRACE transactions," NASD is amending the original proposal to clarify that these debt transactions are subject to the TAF. Absent this clarification, members could mistakenly interpret these transactions to be exempt from the TAF based on the current exemption from the TAF, aimed at equities, for "transactions by an issuer not involving any public offering within the meaning of Section 4(2) of the Securities Act of 1933."

NASD has requested that the effective date of the assessment of fees on covered TRACE-eligible securities and municipal securities occur the first day of the month, six months after SEC approval of the rule change. This effective date was requested to allow member firms time to make program changes to reflect the addition of two new categories of securities subject to the TAF. NASD believes this should be sufficient time to allow members to make necessary programming changes. NASD will require that members self-report debt transactions subject to the TAF in the same manner that members currently self-report transactions in covered equity securities.

### III. Amendments to the Rule Filing

NASD believes that the foregoing fully responds to material issues raised by commenters to the rule filing. In response to the comments identified above, and upon further consideration of the rule filing, 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**

\* \* \* \* \*

#### **Section 1-- Member Regulatory Fees**

- (a) No Change.
- (b) Each member shall be assessed a Trading Activity Fee for the sale of covered securities.

(1) Covered Securities. For purposes of the rule, covered securities shall mean:

(A) All exchange registered securities wherever executed (except debt securities that are not TRACE-eligible securities);

(B) All other equity securities traded otherwise than on an exchange;

(C) All security futures wherever executed;

(D) All “TRACE-eligible securities” wherever executed, provided that the transaction also is a “reportable TRACE transaction,” as these terms are defined in Rule 6210; and

(E) All municipal securities subject to MSRB reporting requirements.

(2) Transactions exempt from the fee. The following shall be exempt from the Trading Activity Fee:

(A) No Change.

(B) Transactions by an issuer not involving any public offering within the meaning of Section 4(2) of the Securities Act of 1933 (except any “reportable TRACE transaction”).

\* \* \* \* \*

#### IV. Conclusion

NASD has proposed adjusting the rate for covered equity securities; reducing the maximum per trade charge on covered equity securities; and assessing the TAF on TRACE-eligible securities subject to TRACE reporting requirements and municipal securities subject to MSRB reporting requirements. The TAF is a critical component of NASD’s member regulatory fee structure and is assessed to recover costs associated with

supervising and regulating NASD members. NASD believes that the TAF, as amended, continues to meet the standards established in Section 15A(b)(5) of the Act insofar as the TAF constitutes a reasonable fee that is equitably allocated among NASD members. Accordingly, NASD requests that the SEC approve the proposed amendments to the TAF.

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

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34- ; File No. SR-NASD-2003-201)

Self-Regulatory Organizations; Notice of Filing of Amendment No. 1 to Proposed Rule Change by National Association of Securities Dealers, Inc. to Amend the Trading Activity Fee Rate and Add TRACE-Eligible and Municipal Securities as Covered Securities

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on , the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. On , NASD filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The Commission is publishing this notice to solicit 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

NASD is proposing to amend Schedule A of the NASD By-Laws to adjust the Trading Activity Fee (“TAF”) rate for covered equity securities; to reduce the maximum per trade charge on covered equity securities; and to assess the TAF on corporate debt securities that, under the Trade Reporting and Compliance Engine (“TRACE”) rules, are defined as “TRACE-eligible securities” and municipal securities subject to the Municipal Securities Rulemaking Board (“MSRB”) reporting requirements. Below is the text of the

---

<sup>1</sup> 15 U.S.C. § 78s(b)(1).

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

<sup>3</sup> This 19b-4 filing represents Amendment No. 1 to File No. SR-NASD-2003-201.

proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

\* \* \* \* \*

**Schedule A to NASD By-Laws**

\* \* \* \* \*

**Section 1-- Member Regulatory Fees**

(a) No Change.

(b) Each member shall be assessed a Trading Activity Fee for the sale of covered securities.

(1) Covered Securities. For purposes of the rule, covered securities shall mean:

(A) All exchange registered securities wherever executed (except debt securities that are not TRACE-eligible securities);

(B) All other equity securities traded otherwise than on an exchange;

(C) All security futures wherever executed;

(D) All "TRACE-eligible securities" wherever executed, provided that the transaction also is a "reportable TRACE transaction," as these terms are defined in Rule 6210; and

(E) All municipal securities subject to MSRB reporting requirements.

(2) Transactions exempt from the fee. The following shall be exempt from the Trading Activity Fee:

(A) No Change.

(B) Transactions by an issuer not involving any public offering within the meaning of Section 4(2) of the Securities Act of 1933 (except any “reportable TRACE transaction”).

\* \* \* \* \*

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

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

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

(1) Purpose

**Background**

On July 24, 2002, NASD filed with the SEC proposed changes to the Gross Income Assessment (“GIA”), Personnel Assessment (“PA”),<sup>4</sup> and Regulatory Fee.<sup>5</sup> Those fees are used to fund NASD’s member regulatory activities, including the regulation of members through examinations, processing of membership applications, financial monitoring, policymaking, rulemaking, and enforcement activities. The

---

<sup>4</sup> Securities Exchange Act Rel. No. 46416 (Aug. 23, 2002), 67 FR 55901 (Aug. 30, 2002) (approving as immediately effective SR-NASD-2002-98, a TAF pilot program). NASD subsequently filed SR-NASD-2002-148 to give the proposal in SR-NASD-2002-98 a full notice and comment period and to adopt a permanent TAF program. See Securities Exchange Act Rel. No. 46817 (Nov. 12, 2002), 67 FR 69785 (Nov. 19, 2002).

<sup>5</sup> Securities Exchange Act Rel. No. 46417 (Aug. 23, 2002), 67 FR 55893 (Aug. 30, 2002) (SR-NASD-2002-99).

changes: (1) eliminated the Regulatory Fee; (2) instituted a new transaction-based TAF applied across all markets, similar to the SEC's Section 31 Fee; (3) increased the rates assessed to member firms under the PA; and (4) implemented a simplified three-tiered flat rate for the GIA whereby deductions and exclusions would be eliminated.

The new member regulatory structure, as approved by the SEC,<sup>6</sup> is revenue neutral to NASD and designed to better align NASD's regulatory fees with its functions, efforts, and costs. To ensure a member regulatory structure that is revenue neutral to NASD, NASD committed to analyze rates, volumes, and regulatory responsibilities periodically to sustain adequate funding levels for its member regulatory programs.<sup>7</sup> Further, as part of a three-year phase-in plan included in the originally proposed pricing structure, NASD stated its intent to reduce the revenue from the collection of the TAF by approximately 50% over the three-year period, offset by an increase in the Personnel Assessment. Finally, in response to comments from a number of members and other self-regulatory organizations about the scope of the TAF, NASD committed to analyzing whether debt transactions should be included.

### **Proposed Changes**

NASD has proposed adjusting the rate for covered equity securities; reducing the maximum per trade charge on covered equity securities; and assessing the TAF on corporate debt securities that, under the Trade Reporting and Compliance Engine ("TRACE") rules, are defined as "TRACE-eligible securities" and on municipal

---

<sup>6</sup> Securities Exchange Act Rel. No. 47946 (May 30, 2003), 68 FR 34021 (June 6, 2003) (approving SR-NASD-2002-148) and Securities Exchange Act Rel. No. 47106 (Dec. 30, 2002), 68 FR 819 (Jan. 7, 2003) (approving SR-NASD-2002-99).

<sup>7</sup> Specifically, NASD stated in the text of the TAF rule that it will "periodically review these revenues in conjunction with these costs to determine the applicable rate." NASD By-Laws, Schedule A, Section 1(a).

securities subject to the Municipal Securities Rulemaking Board (“MSRB”) reporting requirements. In addition, NASD is submitting Amendment No. 1 to the rule proposal. It is intended to clarify that the TAF is assessed on TRACE-eligible securities that also are “reportable TRACE transactions” and that “any reportable TRACE transactions” are not exempt under Schedule A to NASD By-Laws, Section 1(b)(2)(B). NASD hereby requests that the SEC find good cause pursuant to Section 19(b)(2) for approving this amendment on an accelerated basis. NASD notes that this proposal, in substantially the same form, was previously published in the Federal Register for notice and comment. Moreover, NASD would like to ensure the rate reduction for covered equity securities included in this proposal is implemented promptly.

(2) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(5) of the Act, 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 that NASD operates or controls. In this rule filing, NASD is reducing the TAF rate and the maximum TAF assessment per transaction on covered equity securities. In addition, NASD is assessing the TAF on TRACE-eligible securities and municipal securities subject to MSRB reporting requirements. These changes are consistent with NASD’s statutory obligation under Section 15A(b)(5) of the Act to ensure that its fees are reasonable and equitably allocated.

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

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

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

The proposed rule filing was published for comment in the Federal Register on January 28, 2004.<sup>8</sup> Fourteen comments were filed with the SEC. Below is a summary of the comments received and NASD's response.

(1) Proposal Lacks Sufficient Financial Information

Six commenters believe that the proposal does not contain sufficient information for the SEC to determine that it provides for the "equitable allocation of reasonable dues, fees, and other charges" as required by the Securities Exchange Act of 1934 (the "Act").<sup>9</sup> These commenters believe that NASD should provide financial information in the rule filing to allow the SEC and commenters to evaluate the merits of the proposal, such as an accounting of revenue generated by the TAF and the regulatory costs associated with overseeing the debt markets. In addition, five commenters do not believe that there is a nexus between the TAF and the regulatory costs it seeks to fund.<sup>10</sup>

Following an earlier notice and comment period, the SEC previously approved NASD's member regulatory pricing structure as being consistent with Section 15A(b)(5) of the Act, and thus "reasonable" and "equitably allocated" to recover NASD costs

---

<sup>8</sup> Notice of Filing of Proposed Rule Change by NASD To Amend the Trading Activity Fee Rate and Add TRACE Eligible and Municipal Securities as Covered Securities, Exchange Act Rel. No. 49114 (Jan. 22, 2004), 69 FR 4194 (Jan. 28, 2004) (SR-NASD-2003-201).

<sup>9</sup> RW Smith; BMA; STANY; Chapdelaine Corporate; Rafferty; and The MuniCenter.

<sup>10</sup> RW Smith; BMA; STANY; Chapdelaine Corporate; and Rafferty.

related to the regulation and oversight of its members.<sup>11</sup> Notably, in approving the TAF, the SEC urged NASD to implement the TAF “in all areas the NASD must oversee, to better allocate regulatory costs to these activities.”<sup>12</sup> This proposal extends NASD’s approved pricing structure to TRACE-eligible securities and municipal securities, areas over which NASD exercises primary examination and enforcement authority and responsibility. That authority provides the direct nexus to the areas proposed to be covered by the TAF, in accordance with the SEC’s suggested approach. Further, NASD need not specify costs and revenues on a product-by-product basis to demonstrate that the fee is consistent with Section 15A(b)(5) of the Act.

(2) Duplicate Assessments

Nine commenters question whether the proposal constitutes double taxation and state that it fails to consider existing regulatory fees,<sup>13</sup> with a subset of those commenters stating that SRO fees should be coordinated across all SROs with overlapping jurisdiction.<sup>14</sup> Five commenters note that the MSRB (not NASD) provides rulemaking

---

<sup>11</sup> Securities Exchange Act Rel. No. 47946 (May 30, 2003), 68 FR 34021 (June 6, 2003) (approving SR-NASD-2002-148) and Securities Exchange Act Rel. No. 47106 (Dec. 30, 2002), 68 FR 819 (Jan. 7, 2003) (approving SR-NASD-2002-99).

<sup>12</sup> Id.

<sup>13</sup> RW Smith; BMA; Kirkpatrick, Pettis; Chapdelaine; Chapdelaine Corporate; Rafferty; Bear, Stearns; The MuniCenter; and Edward Jones. In addition, several of these same commenters are concerned that increased fees will adversely affect secondary fixed income securities trading. Commenters generally state that assessing such fees when the costs to do business continue to increase (without any offsetting increase to revenues) is inappropriate. Specifically, some of these same commenters note regulatory costs have substantially increased due to significant increases in NASD’s gross revenue assessment, NASD’s personnel assessment, new TRACE fees, and expenses firms must pay to ensure compliance with these regulations. NASD has established a member regulatory pricing structure that is revenue neutral to NASD and that was approved by the SEC as reasonable and equitably. This fee structure aligns NASD’s regulatory fees with its functions, efforts, and costs. While regulatory fees generally constitute additional cost for member firms, these costs are necessary, especially in a highly regulated industry such as the securities industry.

<sup>14</sup> RW Smith; BMA; and Bear, Stearns & Co.

and policy functions for municipal securities and that the fees that the MSRB already charges should be used to fund all regulation.<sup>15</sup> Furthermore, four commenters assert that TRACE transaction fees already include a charge that was intended to recover costs incurred to oversee the corporate debt market, making the extension of the TAF to TRACE-eligible securities unnecessary.<sup>16</sup>

NASD believes that extending the TAF to corporate and municipal debt does not constitute a redundant assessment on top of either TRACE fees or MSRB fees. NASD is responsible for enforcing MSRB rules, which includes supervising and regulating its members' activities in municipal securities through examinations, financial monitoring, and, as appropriate, disciplinary actions. NASD does not receive any portion of the fees that the MSRB collects from its members, and must directly fund the attendant regulatory costs. Accordingly, the assessment of the TAF on municipal securities to recover NASD member regulatory costs is clearly consistent with the Act.

Furthermore, regulatory costs currently funded by the TRACE fee structure are not funded by any other fees or assessments of NASD. This will continue to be the case after the TAF is extended to corporate and municipal debt. Consequently, NASD will not charge duplicative member regulatory fees on TRACE-eligible securities. As represented in SR-NASD-2003-157, NASD will consider the overall financial effect on TRACE participants of any new NASD fees imposed on TRACE-eligible securities, such as the TAF.

---

<sup>15</sup> RW Smith; BMA; Chapdelaine; Edward Jones; and Kirkpatrick, Pettis. In addition, The MuniCenter notes that the numerous fees in the fixed income community are difficult to track and monitor, leading to greater amounts of time needed to ensure proper billing. The commenter asks that a more simple and equitable fee structure be devised.

<sup>16</sup> Edward Jones; RW Smith; BMA; and Bear, Stearns.

(3) TAF Is Assessed On Multiple Parties To A Transaction And Does Not Address Competitive Issues

Three commenters state that they are concerned that two different parties are paying the same fees on the same transactions.<sup>17</sup> Similarly, one commenter asserts that the proposal does not preclude the imposition of two charges on a transaction involving a sale by a customer to the firm followed by the sale to another customer from the firm's inventory.<sup>18</sup> Another commenter asserts that, as a result, transactions between dealers and non-dealers will require Alternative Trading Systems ("ATs") to pay two TAF fees.<sup>19</sup> This commenter asserts that ATs will have to pay double the costs of traditional "players."<sup>20</sup> In addition, three commenters believe that NASD has failed to address the competitive burdens on municipal securities dealers that compete with bank municipal securities dealers that are not NASD members and therefore not subject to the TAF.<sup>21</sup> Furthermore, two commenters note that, as intermediaries, they cannot pass these costs on to their broker-dealer customers because these customers are already paying fees on the same transactions.<sup>22</sup>

NASD recognizes that two TAF fees will be charged in certain circumstances. This is consistent with how the fees are charged on covered equity securities, and is

---

<sup>17</sup> Chapdelaine; Chapdelaine Corporate; and Rafferty.

<sup>18</sup> Edward Jones.

<sup>19</sup> The MuniCenter.

<sup>20</sup> Id.

<sup>21</sup> RW Smith; BMA; and Chapdelaine.

<sup>22</sup> Chapdelaine and Chapdelaine Corporate.

reflective of the fact that interactions with customers are a primary driver of member regulatory costs. NASD devised the TAF as one component for recovering its member regulatory costs, with the focus of the TAF being a member firm's individual trading activity. If a member firm's business model is to regularly engage in transactions with customers, then the member will be assessed in accordance with this activity and in conformity with NASD's member regulatory costs. This policy is consistently applied to all members for transactions in covered securities.

With respect to potential disparities with fees imposed on bank municipal securities dealers that are not NASD members, NASD is not in a position to comment on the manner in which banking regulators assess their regulated institutions for the costs of oversight. NASD re-emphasizes, however, that the TAF serves to recover NASD's costs of member regulatory services in conformity with NASD's statutory obligations. NASD has met its obligation to demonstrate that its fees are reasonable and fairly allocated among its members. Moreover, NASD has structured its member regulatory fee program, as approved by the SEC, in a manner that does not impose burdens on competition that are not necessary or appropriate in furtherance of the Act.

Lastly, with respect to intermediaries' assertions that they are not able to pass these costs onto their broker-dealer customers, the decision of whether to pass costs onto a firm's customers is a business decision that must be made by the individual firm. There is nothing inherent in these fees that calls for passing them onto a firm's customers.

(4) Other SROs May Adopt Such Fees

Two commenters are concerned that other SROs may adopt similar fees on certain fixed income markets. They assert that the lack of supporting disclosure in the proposal

may prompt other SROs to impose new fees or increase current fees without providing assurances that the fees are related to their regulatory costs.<sup>23</sup>

The proposed fees are directly related to NASD's responsibilities to oversee activities in the debt markets. In approving the original TAF filing, the SEC stated that it does not believe that an SRO can impose fees on transactions executed on markets for which the SRO either has little or no nexus to regulatory tasks performed by the SRO or for which the SRO has no business interest. Most SROs do not have the broad regulatory responsibilities that NASD has regarding members' activities with customers, and, in NASD's view, are unlikely to demonstrate a sufficient regulatory nexus to impose a transaction fee on fixed income securities transactions that do not occur in the SRO's market.

(5) Proposed Fee Will Adversely Impact Certain Firms

Three commenters believe that the proposal will have a disparate impact on retail-oriented firms and investors because it effectively reduces the marginal costs of larger transactions.<sup>24</sup> One of these commenters further states that the application of one fee to all trades is possibly unfair to retail firms because the new cap would disadvantage firms whose business model is to engage in many "smaller" transactions, as opposed to those

---

<sup>23</sup> RW Smith and BMA.

<sup>24</sup> RW Smith; BMA; and Edward Jones. These same commenters believe that the TAF should be assessed equitably on a sliding scale similar to that used to assess TRACE fees; however, the sliding scale TRACE fee, which is one of three different TRACE fee schedules, was appropriately established to recover developmental and operational costs from users of the TRACE system. The TAF, in contrast, is based on SEC Section 31 regulatory fees and is aimed at recovering NASD's broad based member regulatory costs. The TAF is an SEC-approved methodology and, when viewed in conjunction with the GIA and PA, serves as an effective proxy for what drives NASD member regulatory costs.

who engage in larger transactions on behalf of institutional clients.<sup>25</sup> Similarly, another commenter claims that, with the maximum fee of \$.75 per trade, the proposal appears to unfairly target smaller transactions.<sup>26</sup>

NASD recognizes that the imposition of the proposed fee cap generally would result in assessing a higher aggregate fee on certain retail activity, when occurring in numerous smaller trades, than would result if the same volume of activity were to occur in, for example, one institutional trade; however, retail trades generally drive member regulatory costs as much as, if not more than, institutional trades, and a higher number of trades results directly in higher member regulatory costs. Accordingly, NASD has proposed a cap consistent with its goal of assessing a reasonable fee that is fairly allocated among its membership and that is reflective of NASD's regulatory functions, efforts, and costs.

(6) Proposal Does Not Provide Details Regarding Its Implementation

Three commenters believe that NASD should clarify whether, or to what extent, existing NASD guidance on the application of the TAF to equities would apply to covered debt securities.<sup>27</sup> For example, the commenters question how agency and riskless principal guidance currently applicable to equities would be applied to the TAF for debt. In addition, these commenters inquire whether the TAF will be charged on the buy side as is done for customer transactions in equities. These commenters assert that applying this interpretation to covered debt securities would result in a significantly greater number of trades in debt being subject to the TAF since broker-dealers engaging

---

<sup>25</sup> Edward Jones.

<sup>26</sup> Associated Bond Brokers.

<sup>27</sup> RW Smith; BMA; and UBS.

in debt activities more often trade as principal (instead of engaging in a contemporaneous sale as agent or acting in a riskless principal capacity, as is typical in equities).

Consequently, the commenters believe that they will more often be charged for both the buy from the customer and the subsequent sell to a broker-dealer.

These same commenters also ask why NASD should charge the TAF on all TRACE-eligible securities without regard to whether the transactions at issue are subject to TRACE reporting. They claim this will cause significant operational and system issues in connection with trades that are not required to be reported, such as repo transactions. Accordingly, they suggest exempting from the TAF those transactions that are not reported to TRACE. These commenters also believe that NASD should identify any differences between the manner in which trades in covered securities are currently reported and the manner in which they would be required to be monitored and reported for the TAF. Lastly, the commenters question whether the effective date provides sufficient lead-time to make the requisite system/programming changes.

NASD will address interpretive issues with respect to the application of the TAF to debt securities in a Notice to Members, as it has done in the case of covered equity securities. NASD, in general, expects to apply the TAF to equity and debt securities in as consistent a manner as possible; however, if members can demonstrate that there are specific scenarios for which the TAF should apply differently to debt than to equities, NASD will consider such information before issuing interpretive guidance with respect to debt.

In response to commenters' concerns that the TAF be assessed only on TRACE-eligible securities subject to TRACE reporting requirements, NASD has determined to

amend its filing to clarify that the TAF will only be assessed on “TRACE-eligible securities” where the transaction also is a “reportable TRACE transaction,” as those terms are defined in NASD Rule 6210. In addition, because debt securities that are issued pursuant to Section 4(2) of the Securities Act of 1933 and re-sold pursuant to Rule 144A in secondary market transactions are “reportable TRACE transactions,” NASD is amending the original proposal to clarify that these debt transactions are subject to the TAF. Absent this clarification, members could mistakenly interpret these transactions to be exempt from the TAF based on the current exemption from the TAF, aimed at equities, for “transactions by an issuer not involving any public offering within the meaning of Section 4(2) of the Securities Act of 1933.”

NASD has requested that the effective date of the assessment of fees on covered TRACE-eligible securities and municipal securities occur the first day of the month, six months after SEC approval of the rule change. This effective date was requested to allow member firms time to make program changes to reflect the addition of two new categories of securities subject to the TAF. NASD believes this should be sufficient time to allow members to make necessary programming changes. NASD will require that members self-report debt transactions subject to the TAF in the same manner that members currently self-report transactions in covered equity securities.

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

NASD has requested that the Commission find good pursuant to Section 19(b)(2) for approving the proposed rule change prior to the 30<sup>th</sup> day after publication in the Federal Register. The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to NASD

and, in particular, Section 15 A and the rules and regulations thereunder. The Commission finds good cause for approving the proposed rules change, as amended, prior to the 30<sup>th</sup> day after the date of publication of the notice of filing thereof in that accelerated approval will ensure the rate reduction and maximum per trade charge for covered equity securities included in this proposal is implemented promptly. In addition, the Commission notes that the proposed amendments relating to assessing the TAF on “TRACE-eligible securities” that are “reportable TRACE transactions” and municipal securities subject to MSRB reporting requirements will not take effect until the first day of the month, six months after SEC approval of the rule change, this will allow NASD member firms to make the necessary to allow member firms time to make programming changes to reflect the addition of a new category of covered securities.

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

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

#### IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington,

D.C. 20549. Comments may also be submitted electronically at the following e-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. SR-NASD-2003-201. This file number should be included on the subject line if e-mail is used. To help us process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

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

Margaret H. McFarland  
Deputy Secretary