

Special Notice to Members

JUNE 2003

SUGGESTED ROUTING

Senior Management
Legal and Compliance
Operations Managers

INFORMATIONAL

Trading Activity Fee

SEC Approves Revisions to NASD By-Laws Regarding Trading Activity Fee

KEY TOPICS

Fees
NASD By-Laws

Executive Summary

On May 30, 2003, the Securities and Exchange Commission ("SEC" or "Commission") approved revisions to NASD By-Laws, eliminating the current Regulatory Fee assessed upon NASD members and instituting a new transaction-based Trading Activity Fee ("TAF").¹ Approval of the TAF, along with previously approved revisions to both the Gross Income Assessment ("GIA") and the Personnel Assessment ("PA"), completes NASD's restructuring of its member regulatory pricing structure. The By-Laws, as amended, are set forth in Attachment A.

Questions/Further Information

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

Discussion

On July 24, 2002, NASD filed a proposed rule change for immediate effectiveness to amend Section 8 of Schedule A to NASD's By-Laws to eliminate the Regulatory Fee and institute a new transaction-based TAF.² This rule filing was part of a proposed restructuring of NASD's member regulatory pricing structure composed of four components that: (1) eliminated the Regulatory Fee; (2) instituted a new transaction-based TAF 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 and eliminated current deductions and exclusions. The revisions to the GIA and PA were approved by the SEC in December 2002 and were reflected in the 2003 annual invoicing of both the GIA and PA.

On October 18, 2002, NASD filed a rule proposal sunsetting the TAF effective December 31, 2002,³ and re-filed the proposal under Section 19(b)(2) of the Securities Exchange Act of 1934 ("Act") to allow for additional member comment.⁴ On December 24, 2002, NASD extended the TAF in its current form as a pilot program through March 1, 2003.⁵ NASD subsequently extended the pilot program through June 1, 2003.⁶

The SEC approved the TAF on a permanent basis on May 30, 2003. The TAF, as approved, is substantially similar to the TAF that has been in effect since October 1, 2002, with two notable exceptions. First, Section 1(b)(2) was amended to incorporate certain exemptions into the text of the rule.⁷ Second, listed options transactions executed by broker/dealers for which NASD is not the primary regulator are exempted from the TAF, effective January 1, 2004.⁸ The permanent TAF will continue to be self-reported in the same manner as during the pilot period.⁹

As noted in the original NASD rule filings and throughout the notice and comment period, NASD designed the overall effect of the revisions to its member regulatory pricing structure to be revenue neutral. Although the structure is fixed, TAF rates will be adjusted as necessary to adapt to the changing activity levels or NASD funding requirements. NASD analysis of the TAF results for the first half of the year suggests that the rates as applied to

actual volumes are inconsistent with the intended fee structure and that rate adjustments will be necessary shortly. Any proposed rate adjustments will be filed as rule changes with the SEC and will be subject to a notice and comment period, as well as SEC approval.

In connection with the approval of the TAF, NASD continues to receive questions regarding the application of the TAF to particular scenarios. The following questions and answers are published to address some of these scenarios and to provide additional guidance. NASD also has addressed questions raised in connection with its new fee structure in *Notices to Members 02-41, 02-63, and 02-75*. Members should consult these *Notices to Members* for further information. The guidance contained herein is not intended to provide an exhaustive analysis of all circumstances that could possibly arise under the new fee structure. Members should contact the NASD staff listed above in the event they have further questions.

Questions and Answers

- Q1. If my firm purchases a covered security from a customer whose account is not held by my firm, such as a sponsored institution, will I be assessed a fee for those purchases?
- A1. No. Although the TAF is assessed on the buy side of member transactions where the counter party is not a broker/dealer, in transactions where a member purchases a covered security from a non-broker/dealer customer whose account is not carried by the member, such as a sponsored institution, a fee will not be assessed on the member.

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- Q2. If my trader receives a buy order for 400,000 shares that will later be allocated among multiple accounts and sells the entire 400,000 shares as principal, which is reported as such to the tape, is the TAF assessed based on the 400,000 sale from the firm's trading account or on the individual allocations that make up the 400,000 share order?
- A2. A member may choose to calculate the fee based on either the one 400,000 share sale from the firm's proprietary account or at the individual customer account level. However, the methodology chosen by the member to calculate the fee assessment must be consistently applied to all such transactions.
- Q3. My firm clears for non-member broker/dealers that engage primarily in options transactions as exchange specialists. As part of our clearing services, we provide an electronic order delivery system that allows our correspondents to electronically access other market centers, such as SuperMontage, SuperDot, and a variety of ECNs. Our correspondents direct orders through the system to the market center of their choosing and control all aspects of how the order will be executed. However, when trades are executed through this electronic order delivery system, the counter party only sees the identity of the NASD clearing firm (not the non-member correspondent). Does NASD view the clearing firm as the executing broker for purposes of the TAF for executions occurring via these electronic order delivery systems?
- A3. Yes. For TAF purposes, NASD views the clearing firm as the executing broker and will assess a fee on transactions effected through these types of electronic order delivery systems. Based upon these facts, neither NASD nor the contra party to these transactions knows the identity of the correspondent broker/dealer. Accordingly, the clearing firm is identified as the party to the trade and, as such, will be assessed a TAF. (NOTE: Any covered security traded through these electronic order delivery systems will be subject to the TAF unless otherwise exempted. See question 4 below regarding assessment of the TAF on listed options transactions.)
- Q4. Is the TAF charged on listed options transactions?
- A4. Yes. NASD members are assessed the TAF on listed options transactions, regardless of where they are executed, until January 1, 2004. Effective January 1, 2004, listed options transactions will be subject to the TAF only if NASD is that member firm's Designated Options Examining Authority (DOEA).⁹ NASD proposed that the exemption regarding listed options transactions be effective starting January 1, 2004, to provide member firms with time to make necessary programming and billing changes and to synchronize with new, bi-annual DOEA allocations effective on that date. Prior to January 1, 2004, NASD will publish a list of those firms designated to NASD.

Endnotes

- 1 Securities Exchange Act Rel. No. 47946 (May 30, 2003).
- 2 Securities Exchange Act Rel. No. 46416 (Aug. 23, 2002), 67 FR 55901 (Aug. 30, 2002).
- 3 Securities Exchange Act Rel. No. 46818 (Nov. 12, 2002), 67 FR 69782 (Nov. 19, 2002) (SR-NASD-2002-147).
- 4 Securities Exchange Act Rel. No. 46817 (Nov. 12, 2002), 67 FR 69785 (Nov. 19, 2002) (SR-NASD-2002-148).
- 5 Securities Exchange Act Rel. No. 47112 (Dec. 31, 2002), 68 FR 824 (Jan. 7, 2003) (SR-NASD-2002-182).
- 6 Securities Exchange Act Rel. No. 47436 (March 4, 2003), 68 FR 11422 (March 10, 2003) (SR-NASD-2003-26) and Securities Exchange Act Rel. No. 47685 (April 16, 2003), 68 FR 20198 (April 24, 2003) (SR-NASD-2003-73).
- 7 See Attachment A, Section 1(b)(2) for a complete list of transactions exempt from the TAF.
- 8 See question 4 in this *Notice* for a discussion of the exemption for listed options transactions.
- 9 See *Notice to Members 02-75* for detailed submission/payment information, including the Self-Reporting Form that must be used when remitting payment to NASD.
- 10 Currently, approximately 70% of all broker/dealers that conduct a public options business are designated to NASD. Firms designated to any of the remaining six SROs that have regulatory responsibilities for options trading may be paying explicit or implicit regulatory fees to that SRO. See Securities Exchange Act Rel. No. 47577 (March 26, 2003), 68 FR 16109 (Apr. 2, 2003) (SR-PCX-2003-03) (Pacific Exchange rule filing establishing a DOEA fee).

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ATTACHMENT A

Schedule A to NASD By-Laws

Assessments and fees pursuant to the provisions of Article VI of the By-Laws of NASD shall be determined on the following basis.

Section 1— Member Regulatory Fees

(a) Recovery of cost of services. NASD shall, in accordance with this section, collect member regulatory fees that are designed to recover the costs to NASD of the supervision and regulation of members, including performing examinations, processing of membership applications, financial monitoring, and policy, rulemaking, interpretive, and enforcement activities. NASD shall periodically review these revenues in conjunction with these costs to determine the applicable rate. NASD shall publish notices of the fees and adjustments to the assessment rates applicable under this section.

(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:

(i) All exchange registered securities wherever executed (other than bonds, debentures, and other evidence of indebtedness);

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

(iii) All security futures wherever executed.

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

(i) Transactions in securities offered pursuant to an effective registration statement under the Securities Act of 1933 (except transactions in put or call options issued by the Options Clearing Corporation) or offered in accordance with an exemption from registration afforded by Section 3(a) or 3(b) thereof, or a rule thereunder;

(ii) Transactions by an issuer not involving any public offering within the meaning of Section 4(2) of the Securities Act of 1933;

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- (iii) The purchase or sale of securities pursuant to and in consummation of a tender or exchange offer;
 - (iv) The purchase or sale of securities upon the exercise of a warrant or right (except a put or call), or upon the conversion of a convertible security;
 - (v) Transactions that are executed outside the United States and are not reported, or required to be reported, to a transaction reporting association as defined in Rule 11Aa3-1 and any approved plan filed thereunder;
 - (vi) 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, that are subject to Securities Exchange Act of 1934, Section 11(a) and Rule 11a1-1(T)(a) thereunder; however this exemption does not apply to other transactions permitted by Section 11(a) such as bona fide arbitrage or hedge transactions;
 - (vii) Transactions by a firm that is a floor based broker and that is a member of both NASD and a national securities exchange provided that the floor based broker qualifies for exemption from NASD membership under Exchange Act Rule 15b9-1;
 - (viii) Transactions in conventional options;
 - (ix) Transactions in options and futures involving narrow and broad based indexes;
 - (x) Transactions in security futures held in futures accounts; and
 - (xi) Transactions in exchange listed options effected by a member when NASD is not the designated options examining authority for that member. (*exemption (xi) is effective beginning January 1, 2004; please see question 4 in the preceeding Notice for a discussion of this exemption*).

NASD may exempt other securities and transactions as it deems appropriate.

(3) Fee Rates*

(i) Each member shall pay to NASD a fee per share for each sale of a covered equity security.

(ii) Each member shall pay to NASD a fee per contract for each sale of an option.

(iii) Each member shall pay to NASD a fee for each round turn transaction (treated as including one purchase and one sale of a contract of sale for future delivery) of a security future.

(4) Reporting of Transactions. Members shall report to NASD the aggregate share, contract, and/or round turn volume of sales of covered securities in a manner as prescribed by NASD from time to time.

(c) Each member shall pay an annual Gross Income Assessment equal to the greater of \$1,200.00 or the total of:

(1) 0.125% of annual gross revenue less than or equal to \$100,000,000.00;

(2) 0.029% of annual gross revenue greater than \$100,000,000.00 up to \$1,000,000,000.00; and

(3) 0.014% of annual gross revenue greater than \$1,000,000,000.00.

Each member is to report annual gross revenue as defined in Section 2 of this Schedule, for the preceding calendar year.

(d) Each member shall pay an annual Personnel Assessment equal to:

(1) \$75.00 per principal and each representative up to five principals and representatives as defined below;

(2) \$70.00 per principal and each representative for six principals and representatives up to twenty-five principals and representatives as defined below; or

(3) \$65.00 per principal and each representative for twenty-six or more principals and representatives as defined below.

A principal or representative is defined as a principal or representative in the member's organization who is registered with NASD as of December 31st of the prior fiscal year.

Section 2—Gross Revenue for Assessment Purposes

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.

- * Trading Activity Fee rates are as follows: Each member shall pay to NASD \$0.00005 per share for each sale of a covered equity security, with a maximum charge of \$5 per trade; \$0.002 per contract for each sale of an option; and \$0.04 per contract for each round turn transaction of a security future. In addition, if the execution price for a covered security is less than the Trading Activity Fee rate (\$0.00005 for covered equity securities, \$0.002 for covered option contracts, or \$0.04 for a security future) on a per share, per contract, or round-turn transaction basis, then no fee will be assessed.