

Notice to Members

JULY 2002

SUGGESTED ROUTING

Compliance
Legal
Senior Management

KEY TOPICS

Gross Income Assessment
NASD By-Laws
Personnel Assessment
Regulatory Fee

Gross Income Assessment, Personnel Assessment, and Regulatory Fee

NASD Informs Members of Proposed Changes to NASD's Gross Income Assessment, Personnel Assessment, and Regulatory Fee

Executive Summary

NASD is issuing this *Notice to Members* to inform members that NASD's Board of Governors has approved proposed changes to NASD's Gross Income Assessment (GIA), Personnel Assessment, and Regulatory Fee. Under the current structure, these three types of fees and assessments are used to fund NASD's member regulatory activities. The proposed restructuring will be comprised of four important amendments: 1) eliminate the Regulatory Fee; 2) institute a new transaction-based Trading Activity Fee similar to the Securities and Exchange Commission's (SEC) Section 31 Fee; 3) increase the rates assessed to member firms under the Personnel Assessment; and 4) implement a simplified three-tiered flat rate for the GIA and eliminate current deductions and exclusions. The proposed changes are revenue neutral to NASD and strive to better align NASD's member regulatory fees with its functions, efforts, and costs. NASD will be filing these proposals with the SEC shortly. Previously, NASD proposed changes to the Regulatory Fee in *Notice to Members 02-09* and requested comments. NASD received a number of comments on this proposal. As a result, the proposal set forth in *Notice to Members 02-09* is not being pursued. Additionally, this revised proposal takes into consideration those comments received.

These fees assessed upon and paid by member firms are used by NASD to fund NASD's member regulatory activities, including the supervision and regulation of members through examinations, processing of membership applications, financial monitoring, policy, rulemaking, interpretive, and enforcement activities. These amendments to the current pricing structure are intended to serve the following purposes: 1) simplify NASD's fee structure; 2) ensure fairness in NASD's fee structure by assessing higher fees to those member firms that require more NASD regulatory services; 3) assess a transaction-based fee in a manner that, unlike the Regulatory Fee, does not influence where members choose to execute trades; 4) reduce where possible the cyclical nature of the current NASD fee structure; and 5) eliminate NASD's reliance on funds generated from

02-41

the Regulatory Fee on transactions executed through Nasdaq. These changes will also enhance the diversity of revenue sources. This proposal was reviewed, discussed, and is strongly supported by the NASD Small Firm Advisory Board and a working group from the Securities Industry Association.

Currently, there is a lack of standardization, consistency, and uniformity in the manner in which the GIA is reported by and assessed on member firms. Therefore, NASD is proposing to eliminate deductions and exclusions, which have been subject to varying interpretations, and instead apply a three-tiered flat rate applied to gross FOCUS revenue. NASD also proposes to eliminate the existing Nasdaq market-based Regulatory Fee and institute a transaction-based Trading Activity Fee similar to the SEC's Section 31 Fee at a reduction of approximately 50% from current levels. The Trading Activity Fee would be assessed on the sell side of all member transactions in all covered securities regardless of where the trade is executed. To offset the proposed reduction in the Trading Activity Fee and reflect the vast size differential of NASD's member firms, the Personnel Assessment would be raised to a three-tiered rate structure of \$65 to \$75.

Although this proposal would be revenue neutral, there are impacts, both negative and positive, to individual firms due to the realignment of revenues with services rendered. The impact of restructuring these fees would be phased in over a three-year period in order to alleviate significant variances experienced by various member firms.

Questions/Further Information

Questions concerning this *Notice* should be directed to NASD Finance,

at (240) 386-5397, or Division of Regulatory Policy and Oversight, Office of General Counsel, at (202) 728-8071.

Action Requested

NASD encourages member firms to submit formal comments through the SEC once the proposal is filed.

IMPORTANT NOTE: Before becoming effective, any rule change must be approved by the SEC.

Discussion

The GIA, Regulatory Fee, and Personnel Assessment are assessed upon and paid by member firms and used by NASD to fund NASD's member regulatory activities, including the supervision and regulation of members through examinations, processing of membership applications, financial monitoring, policy, rulemaking, interpretive, and enforcement activities. The amendments to this current pricing structure are intended to serve the following purposes: 1) simplify NASD's fee structure; 2) ensure fairness in NASD's fee structure by assessing higher fees to those member firms that require more NASD regulatory services; 3) assess a transaction-based fee in a manner that, unlike the Regulatory Fee, does not influence where members choose to execute trades; 4) reduce the cyclical nature of the current NASD fee structure; and 5) eliminate NASD's reliance on funds generated from the Regulatory Fee on transactions executed through Nasdaq. These changes will also enhance the diversity of revenue sources.

NASD's membership population varies greatly with regard to factors that drive the cost of required regulation. Historically, member regulatory fees were derived

primarily from industry revenues and Nasdaq transactions, while NASD derived minimal fees from the registration of member firm personnel. Analysis revealed that the number of registered persons serves as an effective proxy in determining the frequency of certain types of regulatory efforts, and, therefore, regulatory costs. Therefore, as before, the three critical factors used to measure regulatory cost for NASD member firms are overall size of the member firm, level of trading activity, and number of registered representatives. However, the weight from each, as well as the benchmark used to measure industry revenues and transactions, has been shifted under the proposed amendments to better link the fees assessed under these factors with NASD's costs.

Gross Income Assessment (GIA)

The current GIA is assessed on a member firm's gross FOCUS revenues less various exclusions and deductions. The allowable exclusions and deductions have grown to the point where they totaled over 60% of gross FOCUS revenues in 2001.

Member firms are assessed 0.125% on the net assessable FOCUS revenue that converts into a .0355% effective rate on

gross FOCUS revenues. Member firms having gross FOCUS revenues less than or equal to \$960,000 are assessed at a flat rate of \$1,200.

Under the current fee structure for the GIA, the amount of revenue received by NASD is subject to unpredictable swings due to deductions and exclusions taken by member firms. The exclusions and deductions include interest expense, investment management fees, exchange revenue, and unrelated revenues. In 2001, gross FOCUS revenue increased by 30%, yet the total assessment only increased by 15% due to a disproportionate increase in exclusions and deductions, primarily in interest expense. The proposed amendments to the pricing structure are intended to improve the standardization, consistency, and uniformity in which the GIA is assessed on and paid by member firms.

The proposed GIA solution is similar to that employed by the New York Stock Exchange. The rate would be applied to the gross FOCUS revenue with deductions and exclusions eliminated. Given the diversity and size of our member firms, we propose the following three-tiered rate structure:

Revised Rate Structure:

Gross FOCUS Revenue < or = to \$960 Thousand	Assessed Flat Fee of:	\$1,200
Gross FOCUS Revenue > \$960 Thousand		
Tiered Rate on Gross FOCUS Revenue:	over \$1 Billion	0.014%
	>\$100 Million to \$1 Billion	0.029%
	< or = to \$100 Million	0.125%
Effective Rates at FOCUS Revenue Category Levels:	\$10 Billion	0.017%
	\$1 Billion	0.039%
	\$250 Million	0.067%
	\$100 Million	0.125%

Small member firms with gross FOCUS revenues less than or equal to \$960,000 would continue to be assessed a flat fee of \$1,200. As outlined above, all other member firms will be assessed using a tiered rate based on their gross FOCUS revenues. The higher the gross FOCUS revenue, the lower the effective rate.

This type of rate structure will allow for greater equity among member firms because each member firm will be assessed on the same revenue base. Additionally, the new rate structure will simplify the process because member firms will report only gross FOCUS revenue as currently done on FOCUS form Part II or IIA and will no longer need to report deductions and exclusions.

Trading Activity Fee

NASD currently assesses a Regulatory Fee upon its members, through approximately 250 clearing and self-clearing firms, on all transactions reported through Nasdaq's Automated Confirmation Transaction (ACT) system. There is a 400 share minimum and 7,500 share maximum per transaction.

Under the current structure, this revenue stream is at risk due to marketplace changes and Nasdaq's separation from NASD and registration as a national securities exchange. The current fee structure is out of step with marketplace changes as evidenced by the drastic growth in trading volumes, reductions in average trade size, decimalization, and trading no longer remaining exclusive to the listing exchange. Additionally, this fee is assessed against Nasdaq and other over-the-counter transactions, although revenues are used to support member regulation activities across all markets.

The Regulatory Fee as assessed also has become a factor in determining on which market members choose to execute trades. NASD, by its fee assessment, should not promote or disadvantage one trading venue over alternative trading venues.

The proposal would eliminate the existing Nasdaq market-based Regulatory Fee and would institute a transaction-based Trading Activity Fee similar to the SEC's Section 31 Fee. The proposed fee would be assessed on the sell side of all member transactions in all covered securities regardless of where the trade is executed. Specifically, covered securities would include: 1) all exchange-registered securities wherever executed (other than bonds, debentures, other evidence of indebtedness); 2) all other equity securities traded other than on an exchange; and 3) all security futures wherever executed.

The rate to be assessed for the Trading Activity Fee is currently being developed based on industry data for NASD members' transactions in covered securities. Although the rate has yet to be determined, the revenue generated from this fee will be reduced by approximately 50%.

Traditionally, the Regulatory Fee had been assessed on clearing firms on behalf of members. Although reporting obligations are ultimately the responsibility of the member, the Trading Activity Fee would continue to be assessed directly to the clearing firm responsible for clearing the transaction on behalf of the member firm. Firms will self-report to NASD on a monthly basis the aggregate share, contract, and/or round turn volume of sales of covered securities.

Personnel Assessment

The current Personnel Assessment is a minimal fee of \$10 per registered representative that generates only 4% of total member regulatory fees and inadequately supports NASD's member regulatory costs. The number of registered representatives per firm is a fair and representative measure of the cost of member regulatory activities, yet it has not been used as a significant basis for the assessment of fees. Additionally, based on the current fee structure, some firms with a disproportionately large number of registered representatives yet lower FOCUS revenues are avoiding the payment of the cost of regulation of member firms through the payment of NASD fees.

As part of this proposal, the Personnel Assessment will become a more prominent assessable base for the funding of member regulatory activities. Given the vast size differential of our member firms, NASD proposes the following three-tiered rate structure:

Revised Rate Structure:

Tiered rate on registered reps:

> 25 registered reps	\$ 65.00
6 to 25 registered reps	\$ 70.00
1 to 5 registered reps	\$ 75.00

Phase-In

NASD's overall proposal will be revenue neutral to NASD. However, due to the link of revenues to regulatory services provided, there will be effects, both negative and positive, on individual member firms. To minimize the impact on member firms, the restructuring of fees will be phased in over a three-year period. Specifically, for the Gross Income Assessment, any negative or positive variances experienced by the firms would be phased in at 33% in Year 1, 67% in Year 2 and 100% in Year 3. For the Trading Activity Fee, since the revenue generated from this fee would be reduced by approximately 50%, the fee reduction will be phased in at a rate of 33% in Year 1, 67% in Year 2 and 100% in Year 3. For the Personnel Assessment, since the revenue generated from this fee would be increased to cover the reduction in the Trading Activity Fee, the fee increase will be phased in at a rate of 33% in Year 1, 67% in Year 2 and 100% in Year 3. Based upon a review of the majority of NASD's small member firms, the net increase of fees will average approximately \$100 in Year 1.

Additionally, NASD will continue to reduce these fees through rebates to the member firms in connection with the proceeds raised from the sale of Nasdaq. NASD will continue to use a portion of these rebates to eventually reduce the minimum GIA amount from \$1,200 to \$600. The remaining balance and other additional discretionary rebates will be used to further reduce fees paid to NASD.

Summary

The changes proposed above are intended to stabilize and maintain the existing revenue streams in a neutral manner with minimal impact to NASD's members. NASD will continue to review its overall fee structures to ensure that its assessment methods are modernized and keep pace with industry developments and practices. Additionally, NASD will periodically review the funding from these fees in conjunction with its member regulation costs to make appropriate adjustments to the assessment rates. NASD will publish any adjustments to the assessment rates as determined by this review process.

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ATTACHMENT A

Proposed New Text of 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 Regulation Fees

- (a) Recovery of cost of services. NASD shall, in accordance with this section, collect Member Regulation 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, 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;

- (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; and
- (v) Transactions which 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.

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 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.

Section 3 – SEC Transaction Fee

Each member shall be assessed a SEC transaction fee. The amount shall be determined by the SEC in accordance with Section 31 of the Act.

Section 4 – Fees

No Change to rule language.

Section 5 – Elimination of Duplicate Assessments and Fees

No Change to rule language.

Section 6 – Assessments and Fees for New Members, Resigning Members and Successor Organizations

No Change to rule language.

Section 7 – Fees for Filing Documents Pursuant to the Corporate Financing Rule

No Change to rule language.

Section 8 – Service Charge for Processing Extension of Time Requests

No Change to rule language.

Section 9 – Subscription Charges for Firm Access Query System (FAQS)

No Change to rule language.

Section 10 – Request for Data and Publications

No Change to rule language.

Section 11 – Reserved

No Change to rule language.

Section 12 – Application and Annual Fees for Member Firms with Statutorily Disqualified Individuals

No Change to rule language.

Section 13 – Review Charge for Advertisement, Sales Literature, and Other Such Material Filed or Submitted

No Change to rule language.