

Notice to Members

FEBRUARY 2005

SUGGESTED ROUTING

Finance
Legal & Compliance
Operations
Senior Management

KEY TOPICS

Regulatory Transaction Fees
Section 31 of the Exchange Act
Section 3 of Schedule A to the NASD
By-Laws

GUIDANCE AND REQUEST FOR COMMENT

Regulatory Transaction Fees

NASD Issues Further Guidance Regarding Members' Obligations under Section 3 of Schedule A to the NASD By-Laws; NASD Also Seeks Member Comment on Related Automation Issues; **Comment Period Expires March 30, 2005**

Executive Summary

In August 2004, NASD issued *Notice to Members (NtM) 04-63* (Transaction Fees: New SEC Procedures Relating to Section 31 of the Securities Exchange Act of 1934) informing member firms of the new Securities and Exchange Commission (SEC) procedures governing the calculation, payment, and collection of fees and assessments on securities transactions owed by national securities exchanges and associations to the SEC pursuant to Section 31 of the Securities Exchange Act of 1934 (Exchange Act). *NtM 04-63* also discussed the obligations of member firms under Section 3 of Schedule A to the NASD By-Laws in light of the new SEC procedures.

More specifically, *NtM 04-63* stated that members are required to self-report the following covered securities transactions that are not reported to NASD's trade reporting systems: (1) odd-lot transactions; (2) exercises of over-the-counter (OTC) options that settle by physical delivery; and (3) away from the market sales. In addition, NASD notified members that beginning in September 2004, members must self-report the relevant trade data and submit their payments by the seventh calendar day of each month. Further, NASD informed members that if they pass this regulatory transaction fee onto their customers, they should no longer consistently round up if there is a remainder. Instead, members should alternate between rounding up and rounding down to the next cent when calculating the transaction fees on individual trades. Last, based on statements made by the SEC in its order approving the new SEC procedures, NASD cautioned member firms that they must refrain from labeling the fees assessed by NASD as "Section 31 Fees" or "SEC Fees."

Today, NASD staff is announcing that, beginning in February 2005, all NASD member clearing and self-clearing firms will be required to submit a monthly Self-Reporting Form to NASD regardless of whether they have qualifying transactions for a specific month. The form must be signed by a registered principal indicating the firm has done the necessary review to ensure all qualifying transactions have been properly reported. In addition, **NASD staff is advising NASD members that they should disregard the advice on rounding provided in any previous *NtMs* (including *NtM 04-63*) and *Member Alerts* (including the December 28, 2001, *Member Alert*).** Attachment A to this *NtM* is an updated Self-Reporting Form.

NASD staff is also providing further guidance in this *NtM* in response to a significant number of questions from member firms regarding these obligations.¹ These questions have prompted NASD to seek input from the membership on automating the reporting process for odd-lot transactions, OTC exercised options and away from the market sales. Specifically, NASD is seeking member comment on requiring that all transactions subject to the Regulatory Transaction Fee be reported to an NASD trade reporting system. This proposal would include amending NASD transaction reporting rules to allow for odd-lot transactions, OTC exercised options and away from the market sales to be submitted to an NASD trade reporting system for regulatory reporting purposes. Transactions submitted in this manner would be flagged by NASD's billing system and included in the Regulatory Transaction Fee billing process, but would not be disseminated to the media. NASD foresees that these regulatory reports would follow the same Automated Confirmation Transaction Service (ACT) or Trade Reporting and Confirmation Service (TRACS) fee structure for non-tape, non-clearing entries as exists today (*i.e.*, no ACT or TRACS fee would be charged for the submission of these entries.)

Questions/Further Information

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

Action Requested

NASD encourages all interested parties to comment on the proposed changes to the reporting process for the Regulatory Transaction Fee. Comments must be received by **March 30, 2005**. Members and other interested parties can submit their comments using the following methods:

- ♦ Mailing comments in hard copy to the address below
- ♦ E-mailing comments to pubcom@nasd.com

To help NASD process and review comments more efficiently, persons commenting on this proposal should use only one method; however, if a person wishes to submit comments using both of the methods listed above, he or she should indicate that in the submissions.

Comments sent by hard copy should be mailed to:

Barbara Z. Sweeney
Office of the Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1500

Important Notes: The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web site. Generally, comments will be posted on the NASD Web site one week after the end of the comment period.²

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the NASD Board, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.³

Question and Answers

The following Questions and Answers address a variety of issues that have arisen since the publication of *NtM 04-63*.

Q1. What are away from the market sales?

- A1. Pursuant to NASD's transaction reporting rules, members are required to report transactions in designated securities, with few exceptions. One such exception is transactions where the buyer and seller have agreed to trade at a price substantially unrelated to the current market for the security, and consideration is provided. Such sales are called away from the market sales. Away from the market sales historically have been excluded from the reporting requirements under NASD's transaction reporting rules, including the rules applicable to ACT.⁴

However, given the underlying goals of transaction reporting, NASD interprets the exception from the transaction reporting rules for away from the market sales very narrowly. Specifically, as noted in *NtM 02-76*, an away from the market sale is an execution that occurs without reference to current market pricing and investment, commercial, or trading considerations.⁵ Consequently, NASD staff anticipates that the number of away from the market sales subject to self-reporting pursuant to Section 3 of Schedule A to the NASD By-Laws should be *de minimis*. Members also should note that any sales that are reported to ACT or TRACS are not subject to self-reporting. Moreover, members are not required to self-report transactions involving a gift of a security *without* consideration because such a transaction is not considered a "sale" for reporting purposes.

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- Q2.** In *NtM 04-63*, NASD stated that members should calculate the regulatory transaction fees by: (1) multiplying the aggregate dollar amount of covered sales by the fee rate; (2) truncating the resulting amount at the fifth place after the decimal point; and (3) alternating between rounding up and rounding down to the next cent, if there is any remainder. How should members apply the alternating round up/down methodology? Do members still have the option of solely rounding up to the next cent if there is any remainder following the calculation?
- A2.** The guidance provided in *NtM 04-63* regarding the rounding methodology was intended to prevent the accumulation of any overages that may result from routinely rounding up to the next cent when calculating the transaction fees that firms pass on to their customers by suggesting that firms adopt a standard mid-point rounding convention. Section 3 of Schedule A to the NASD's By-Laws does not dictate whether or how members should charge customers to recover amounts paid to NASD; accordingly, members should disregard the advice on rounding provided in the *NtM 04-63* or any other previous *NtMs* and *Member Alerts* (including the December 28, 2001, *Member Alert*).
- Q3.** Are all member firms required to self-report the applicable trade data and submit payments to NASD?
- A3.** No. Although reporting obligations are ultimately the responsibility of each member firm, only member firms that are clearing firms (including self-clearing firms) should be submitting the self-reported trade data and applicable payments to NASD. Clearing firms are expected to collect any applicable trading information from their respective correspondent firms to be included in the aggregate totals.
- Q4.** Can odd-lot transactions be reported to ACT or TRACS in order to fulfill a member's self-reporting obligation for covered odd-lot sales?
- A4.** Yes. Odd-lot transactions submitted to ACT or TRACS for clearing purposes pursuant to NASD Rule 6130(a) will satisfy a member's self-reporting obligation.⁶ Therefore, any odd-lot sale submitted to ACT (in the manner as prescribed in endnote six) or TRACS for clearing should not be included on the member's Self-Reporting Form. Members should be aware, however, that NASD rules prohibit odd-lot transactions from being reported to NASD trade reporting systems for media dissemination only.⁷ Members, therefore, must use the Self-Reporting Form to satisfy their reporting obligation with respect to odd-lot transactions that are not cleared through ACT or TRACS.

Q5. Does my firm have to submit a Self-Reporting Form if we have no transactions that are subject to the self-reporting requirement?

A5. Yes. Previously, clearing and self-clearing firms were only required to submit an initial Self-Reporting Form indicating that they did not process any transactions falling within the self-reporting requirement. After the initial form, there was no requirement to submit blank forms on a monthly basis. However, to ensure firms' on-going compliance with self-reporting obligations, NASD is now requiring that each clearing and self-clearing firm submit a Self-Reporting Form each month regardless of whether they have qualifying transactions. Additionally, the form must be signed by a registered principal of the firm representing that a review has been performed to ensure all qualifying transactions have been properly reported. This new requirement will begin with January trade data that is due to NASD by February 7, 2005. An updated Self-Reporting Form is included in this *NtM* as Attachment A.

Q6. Does NASD pay the SEC a Section 31 fee on all sales transacted by or through an NASD member?

A6. NASD is responsible for paying fees for sales transacted by or through its members in securities subject to prompt last sale reporting pursuant to the rules of the SEC or NASD and securities that are off-exchange trades of exchange-registered securities. This means that, as a general matter, transactions in equity securities submitted to an NASD trade reporting system for last sale reporting are subject to the fee.⁸ However, certain sales are exempt from the fee. SEC Rule 31(a)(11) states that the following sales are exempt: (i) any sale of a security offered pursuant to an effective registration statement under the Securities Act of 1933 (except a sale of a put or call option issued by the Options Clearing Corporation) or offered in accordance with an exemption from registration afforded by section 3(a) or 3(b) of the Securities Act of 1933, or a rule thereunder; (ii) any sale of a security by an issuer not involving any public offering within the meaning of section 4(2) of the Securities Act of 1933; (iii) any sale of a security pursuant to and in consummation of a tender or exchange offer; (iv) any sale of a security upon the exercise of a warrant or right (except a put or call), or upon the conversion of a convertible security; (v) any sale of a security that is executed outside the United States and is not reported, or required to be reported, to a transaction reporting association as defined in §240.11Aa3-1 and any approved plan filed thereunder; (vi) any sale of an option on a security index (including both a narrow-based security index and a non-narrow-based security index); (vii) any sale of a bond, debenture, or other evidence of indebtedness; and (viii) any recognized riskless principal sale.

Q7. Our firm has decided to pass on the Regulatory Transaction Fees assessed by NASD to our broker-dealer customers. Is it acceptable to use the Step-Out function in ACT for the specific purpose of transferring the transaction fees to broker-dealer customers?

A7. No. As explained in *NtM 98-40* (Nasdaq To Incorporate Trade Acceptance And Reconciliation Service Into Automated Confirmation Transaction Service) (May 1998), ACT provides a Step-Out function to allow members to “step out,” or allocate, all or part of a previously executed trade to another broker-dealer. In other words, a Step-Out functions as a position transfer, rather than a trade. The Step-Out function was designed and implemented to facilitate the clearing process for members involved in these types of transactions. As part of the Step-Out function, ACT also provides the ability to move the transaction fee associated with the trade to the ultimate seller of the security when the trade is allocated. However, the Step-Out functionality was not intended to serve as a means to transfer transaction fees related to trades that do not fit ACT’s definition of a Step-Out. Using the Step-Out flag on transactions that do not meet ACT’s definition of a Step-Out results in such transactions being incorrectly characterized in NASD’s audit trail. Because NASD relies on the audit trail for regulatory and surveillance purposes, it is critical that all transactions submitted to ACT be reported in accordance with the ACT rules to ensure the integrity of the information contained in the audit trail.

Q8. Where do member firms send the monthly self-reporting form?

A8. Member firms should submit the Permanent Self-Reporting Form and payment to NASD, P.O. Box 7777-W4230, Philadelphia, PA 19175-4230.

Endnotes

- 1 NASD filed this *NtM* on February 4, 2005, with the SEC for immediate effectiveness. See SR-NASD-2005-021 (Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Additional Guidance Regarding Members' Obligations under Section 3 of Schedule A to the NASD By-Laws).
- 2 See *NtM 03-73* (November 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or e-mail addresses, will not be edited from submissions. Persons commenting on this proposal should submit only information that they wish to make publicly available.
- 3 Section 19 of the Exchange Act permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and rules thereunder.
- 4 See NASD Rules 4632(e)(5), 4642(e)(4), 4652(e)(3), 6230(e)(3), 6420(e)(5), and 6920(e)(2) (providing that away from the market sales—for example, to make a gift—need not be reported).
- 5 See *NtM 02-76* (November 2002) (Corporate Debt Securities Transactions Subject to Reporting and Dissemination; NASD Issues Interpretive Guidance to the Trade Reporting and Compliance Engine Rules (TRACE Rules)).
- 6 Firms should note that in order for odd-lot transactions submitted to ACT to be billed automatically by NASD, the trade must be submitted to ACT for both reporting and clearing. The reporting designation of the entry is used to identify the trade as eligible for the Regulatory Transaction Fee in NASD's billing system. Note that ACT automatically suppresses the trade from media dissemination.
- 7 See, e.g., Rule 4623(e)(2).
- 8 The fee, however, does not apply to non-Canadian foreign securities submitted to an NASD trade reporting system since these securities are generally not subject to prompt last sale reporting (reported on a T+1 basis).

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ATTACHMENT A

NASD Permanent Self-Reporting Form for Odd-Lot Transactions, OTC Exercised Options, and Away from the Market Sales

*****Effective January 7, 2005*****

Important Note: Only NASD members that are clearing firms (including self-clearing firms) should be submitting this form on a monthly basis to NASD. All clearing firms are expected to collect any applicable trading information from their respective correspondent firms to be included in the aggregate totals. The trade date must be used when determining aggregate odd-lot and away from the market sales transactions for the preceding calendar month. The exercise date must be used when reporting aggregate OTC exercised option sales for the preceding calendar month.

General Instructions

The purpose of this form is to facilitate the collection of transaction fees under Section 3 of Schedule A to the NASD By-Laws with respect to transactions in odd-lots, transactions effected pursuant to the exercise of OTC options, and certain transactions that occur away from the market.

Transactions of the clearing firm and its correspondents should be consolidated for reporting purposes.

Please retain a copy of this blank form for your firm's monthly reporting. Additional copies of this form may be obtained by contacting the NASD Finance Department at (240) 386-5354.

Each clearing firm must submit this form each month regardless of whether it has reportable transactions. If your firm does not have any reportable transactions for the current month, your firm must submit the blank form signed by an authorized principal, along with a statement that your firm had no reportable transactions for the month.

Odd-Lot Transactions

NASD members that are clearing firms, including self-clearing firms, must report the aggregate dollar amount of covered odd-lot sales transacted by or through such member, including all such sales by the member's correspondent firm(s). Firms must report odd-lot sales under the same general rules and guidelines applicable to round lot transactions as detailed in *Special Notice to Members 96-81* dated December 3, 1996 and the SEC Billing Document from NASD in December 1996. Member firms should consider the following when accumulating odd-lot data for each reporting period:

- Odd-lot transactions are those sides for less than the normal trading unit, e.g., 100 shares. Do not include "mixed lots" as part of your odd-lot reporting.
- Include all transactions where you or your correspondent firms represent the sell side of the odd-lot transaction.
- Include all transactions where you or your correspondent firms represent the buy side of a transaction with or between public customers or non-NASD member firms.
- Include all odd-lot transactions in NASDAQ Equity Securities.
- Include all odd-lot transactions in non-NASDAQ OTC Equity Securities as defined in NASD Rule 6610.
- Include all odd-lot transactions in non-NASDAQ OTC Equity Securities that are ADRs or Canadian foreign securities but exclude all non-NASDAQ non-Canadian foreign securities.
- Include all odd-lot transactions in exchange-registered securities traded off the exchange ("third market trades").
- Do *not* include odd-lot transactions that were reported to TRACS or that were submitted to ACT for clearing and reporting (see endnote three in *NTM 05-11*). This form must only be used for odd lots that are not reported to TRACS or that were not submitted to ACT for *both* reporting and clearing (e.g., an entry marked as clearing only will not be automatically billed by NASD).

OTC Option Exercise

Use this section of the form to report all transactions in a covered security effected pursuant to the exercise of an OTC option by or through a member that is a clearing firm (including self-clearing firm) or its correspondent firm(s). Covered securities are those securities that are subject to prompt last-sale-reporting and exchange-registered securities. Member firms should determine the following when accumulating options exercise data for each calendar reporting period:

- This form is only used to report transactions in covered securities that arise pursuant to the exercise of an OTC option by or through an NASD member that settle by physical delivery. Do not include any exercise of an option not involving the purchase or sale of the underlying covered security, e.g., a cash settled exercise.
- Include all transactions where you or your correspondent firms represent the sell side of the transaction.
- Include all transactions where you or your correspondent firms represent the buy side of a transaction with or between public customers or non-NASD member firms.
- Do not include any transactions in a covered security effected pursuant to the exercise of an exchange-registered option. The Options Clearing Corporation will collect the fee for these types of transactions.
- Report the aggregate dollar amount of the transactions determined on the basis of the exercise price.

Sales Away from the Market

NASD members that are clearing firms (including self-clearing firms) must report the aggregate dollar amount of covered sales where the buyer and seller have agreed to trade at a price substantially unrelated to the current market for the security and where these sales are prohibited from being reported to an NASD trade reporting system pursuant to NASD Rules. Firms should not include transactions involving a gift of a security **without** consideration because such a transaction is not considered a "sale" for purposes of this form.

**NASD Permanent Self-Reporting Form for Odd-Lot Transactions,
OTC Exercised Options, and Away from the Market Sales**

***** Effective January 7, 2005 *****

Regulatory Transaction Fees under Section 3 of Schedule A to the NASD By-Laws for the Calendar Month of _____, 200() for odd-lot transactions, OTC exercised options, and away from the market sales.

Report of Sales by: Firm Name _____

B/D# _____

Clearing# _____

Transaction	Aggregate Sales/Exercise Price	Rate	Fee Due
Odd-Lot Transactions	\$	0.0000329	\$
OTC Exercised Options	\$	0.0000329	\$
Away from the Market Sales	\$	0.0000329	\$

Total Amount Due \$ _____

*****IMPORTANT*** PAYMENT FOR TOTAL AMOUNT DUE MUST BE SUBMITTED WITH THIS REPORT.**

NASD must receive this form and payment by the seventh calendar day¹ subsequent to the subject trade-reporting period. Please submit this form and payment to:

NASD • P.O. Box 7777-W4230 • Philadelphia, PA 19175-4230

Signature of Authorized Principal _____ Title _____

Print Name _____ Date/Telephone Number _____

Address (Street, City, State, Zip) _____

E-mail Address _____

¹ If the seventh calendar day falls on a weekend or a public holiday, the report must be received by NASD on the first business day following the weekend or public holiday.