Notice to Members

MARCH 2005

SUGGESTED ROUTING

Legal and Compliance

Operations Managers

Senior Management

KEY TOPICS

Section 1 of Schedule A to NASD By-Laws

Trading Activity Fee

GUIDANCE

Trading Activity Fee

NASD Issues Further Guidance on the Trading Activity Fee

Executive Summary

On October 1, 2004, the Securities and Exchange Commission (SEC or Commission) approved an NASD rule filing amending the Trading Activity Fee (TAF) that would reduce the TAF rate for covered equity securities, reduce the maximum per trade charge on covered equity securities, and assess the TAF on corporate debt securities that, under the Trade Reporting and Compliance Engine (TRACE) Rules, are defined as "TRACE-eligible securities" that fall within the definition of a "reportable TRACE transaction" (as defined in Rule 6210(c)) and all municipal securities subject to Municipal Securities Rulemaking Board (MSRB) reporting requirements.[1] As previously announced in *Notice to Members (NTM) 04-84*, the TAF will be assessed on "TRACE-eligible securities" that fall within the definition of a "reportable TRACE transaction" (as defined in Rule 6210(c)) and all municipal securities subject to MSRB reporting requirements effective April 1, 2005. In *NTM 04-84*, NASD also requested that members submit written questions concerning any operational aspects of applying the TAF to debt securities so that member firms could program their systems accordingly. NASD received a limited number of written questions in response to *NTM 04-84*.

In this *Notice*, NASD is providing guidance with respect to applying the TAF to debt securities based on the interpretive questions submitted in writing to NASD. In addition, NASD is also addressing additional interpretive questions that have been raised concerning the application of the TAF on other covered security transactions.

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 (240) 728-8071.

Background and Discussion

On December 29, 2003, NASD filed with the Commission a proposed rule change (SR-NASD-2003-201) that would reduce the TAF rate for covered equity securities, reduce the maximum per trade charge on covered equity securities, and assess the TAF on corporate debt securities that, under the TRACE Rules, are defined as "TRACE-eligible securities" that fall within the definition of a "reportable TRACE transaction" (as defined in Rule 6210(c)) and on municipal securities subject to MSRB reporting requirements. In connection with this proposed rule change, NASD reviewed reported volumes for TRACE-eligible securities and municipal securities in conjunction with NASD's current regulatory costs associated with the oversight of these securities. Based upon this review, NASD determined to assess the TAF on TRACE-eligible securities and municipal securities at a rate of $0.00075 per bond, with a maximum assessment of $0.75 per trade (based on 1,000 bonds). The proposed rule change was published for notice and comment in the *Federal Register* on January 28, 2004.[2] On May 19, 2004, NASD filed with the Commission Amendment No. 1 and, at the same time, responded to comments submitted on the proposal. On September 30, 2004, NASD responded to further comments.[3] The SEC approved the proposed rule change on October 1, 2004.[4]

In November 2004, NASD issued *NTM 04-84*, informing member firms that the TAF proposal was approved and of the requisite effective dates. Specifically, NASD implemented the TAF rate reduction and the reduction on the maximum per trade charge on covered securities on November 1, 2004. In addition, NASD announced that it would begin assessing the TAF on "TRACE-eligible securities" that fall within the definition of a "reportable TRACE transaction" (as defined in Rule 6210(c)) and all municipal securities subject to MSRB reporting beginning on April 1, 2005. NASD designated six months after SEC approval as the effective date for covered debt securities to allow members sufficient time to make programming changes to reflect the addition of two new categories of covered securities. Further, in *NTM 04-84*, NASD solicited interpretive questions relating to the operational aspects of assessing the TAF on debt securities. In response to *NTM 04-84*, NASD received a limited number of written questions. In this *Notice*, NASD is providing guidance with respect to applying the TAF to debt securities based on selected interpretive questions submitted in writing to NASD that were pertinent to the operational aspects of assessing the TAF on debt. NASD is also addressing additional interpretive questions that have been raised concerning the application of the TAF on other covered security transactions.

Submission/Payment Information

The TAF for covered equity, options, and security futures transactions is assessed on clearing firms on behalf of members.[5] Likewise, the TAF for covered debt securities will also be assessed directly to the clearing firms (responsible for clearing the transaction on behalf of the member firm) and self-clearing member firms.

Clearing and self-clearing member firms are required to self-report covered securities transactions to NASD for the preceding month's activity each month. The prescribed form of the monthly report is available at *www.nasd.com/trading_activity_fee_0305/*. The monthly report and payment is to be submitted to NASD by the tenth business day following the end of the month. However, to allow firms additional time to comply with the impact of the guidance provided below, NASD has extended the submission and payment date for the April 1, 2005 through June 30, 2005 period for covered debt securities to July 14, 2005. Accordingly, firms may self-report and remit payment to NASD for covered debt securities for this period no later than July 14, 2005. Transactions in covered debt securities for July 1, 2005, and thereafter are to be reported on a monthly basis by the tenth business day following the end of the month.

Firms are reminded that NASD verifies the accuracy of members' self-reporting to ensure the fair assessment of the TAF. Firms are expected to establish and maintain appropriate written supervisory, compliance, legal, internal audit, and operating policies, practices, and procedures sufficient to assure compliance with the TAF self-reporting requirements. The self-reporting verification is performed as part of NASD's regular cycle examinations of members.

The self-reporting form and payment may be submitted to NASD by either U.S. mail or overnight express mail as follows:

For U.S. mail delivery:

NASD
P.O. Box 7777-W8555
Philadelphia, PA 19175-8555

Note: This P.O. Box will not accept courier or overnight deliveries.

For courier and overnight deliveries:

NASD
W8555 c/o Mellon Bank, Rm 3490
701 Market Street
Philadelphia, PA 19106
Phone number: (215) 553-0697 (if required for the recipient)

If other payment methods are required, please call NASD Finance at (240) 386-5394.

Questions and Answers

Covered Debt Securities Transactions

NASD is providing additional guidance with respect to applying the TAF to debt securities based on interpretive questions submitted in writing to NASD.

Question 1:

Will billing and payment mechanisms differ from those existing for TRACE and MSRB transactions? If so, how will firms report such transactions to NASD?

Yes. As discussed above, the TAF for TRACE-eligible securities and municipal securities will be self-reported as is done for equities, options, and futures. Firms are required to self-report covered securities transactions to NASD each month for the preceding month's activity. The monthly report and payment is to be submitted to NASD by the tenth business day following the end of the month. However, for covered debt transactions occurring from April 1 through June 30, 2005, NASD has extended the deadline for the timely submission of the monthly report and payment to July 14, 2005, to allow firms additional time to program in conformity with the guidance provided in this *Notice*.

Question 2:

Will the TAF appear as a component of the TRACE invoice that currently includes Browser Access Fees, Cancelled Trade Fees, Correction Fees, Reversal Fees, and Tier 1-3 Trade Reports Fees?

No. The TAF is a separate fee used by NASD solely 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 TAF, which also applies to covered equity, options, and security futures transactions, is separate and apart from TRACE-related fees that are used to fund, among other things, operation of the TRACE system.

Question 3:

Does the TAF apply to government securities?

No. The only debt securities covered by the TAF are corporate debt securities that, under the TRACE Rules, are defined as "TRACE-eligible securities" that fall within the definition of a "reportable TRACE transaction" (as defined in Rule 6210(c)) and all municipal securities subject to MSRB reporting requirements.

Question 4:

Does the TAF apply only to sell trades?

Yes. Section 1 of Schedule A to NASD By-Laws provides that members shall be assessed a TAF for the sale of covered securities. As stated in *NTM 02-75*,[6] the sale of a covered security includes both transactions where the sale is for the account of a customer and transactions where the sale is for the member itself. For transactions where the sale is for the account of a customer, this means that the TAF will be assessed on transactions in which a member purchases the security as principal from a customer (for purposes of the TAF, customer is defined as not a broker-dealer) or where the member acts as agent in the sale of a covered debt security on behalf of a customer.

Question 5:

With regard to the calculation of the fee, *NTM 04-84* states "NASD is assessing the TAF on TRACE-eligible securities and municipal securities at a rate of $0.00075 per bond, with a maximum assessment of $0.75 per trade (based on 1,000 bonds)." Please confirm that in this statement the term "bond" or "one bond" equals a principal amount of debt of $1,000. Therefore, the maximum fee would be applied to trades of $1,000,000 principal amount (1,000 bonds) or greater.

Yes. Generally, the term "bond" or "one bond" equals a principal amount of debt of $1,000. There are some special circumstances, however, where the principal amount of one bond could be something other than $1,000 (such as so-called "baby bonds"). In these special circumstances, the maximum fee should be calculated using the actual number of bonds and not $1,000,000.

Question 6:

Will the current guidance for riskless principal equity transactions apply to TRACE and MSRB transactions?

No. MSRB and TRACE trade reporting rules do not provide for reporting or identifying a transaction as a riskless principal transaction.[7] Accordingly, the guidance provided for riskless principal equity transactions does not apply to TRACE and MSRB transactions. This means that in instances where a member, after having received an order to sell a covered debt security from a customer, sells the security as principal to satisfy the customer's order and then buys the security as principal from its customer, the TAF will be assessed on both the member's purchase of the debt security from the customer as a principal and the member's sale of the debt security as a principal.

In the same scenario above, if the original sell order is received from another broker-dealer rather than a customer, the firm acting as the intermediary will only be assessed the TAF once. Under this scenario, the TAF for the offsetting purchase will instead be assessed on the broker-dealer that placed the order to sell with the intermediary.

Question 7:

TRACE transaction reporting rules require that two transaction reports be submitted to TRACE when a member acts as agent on behalf of a customer.[8]

For example, broker #1 receives an order from a customer to buy 100 bonds. Acting as the customer's agent, broker #1 buys the bonds from broker #2. The TRACE reports required of broker #1 would be as follows:

Report #1: broker #1 SELL 100 bonds to customer as agent

Report #2: broker #1 BUY 100 bonds from broker #2 as agent

Although broker #1 BOUGHT the bonds for its customer, it actually reported a SELL to the customer, followed by a BUY from broker #2.

How many TAF fees are assessed for this trade and which broker(s) is/are assessed?

For purposes of applying the TAF to covered debt transactions, NASD defines an agency trade as a trade in which a broker-dealer, authorized to act as an intermediary for the account of its customer or another broker-dealer, buys (sells) a covered debt security from (to) a third party (*e.g.*, another customer or broker-dealer). Such a trade is not executed in, or does not otherwise pass through, the broker-dealer's proprietary account, and is appropriately identified on firm transaction records as an agency transaction.
In the above example, this means that only broker #2 would be assessed a TAF since broker #1 has not effected a sale either as principal or on behalf of a customer. If broker #1, however, records the transaction in a firm account prior to satisfying the customer's order to buy, the TAF would also be assessed on broker #1 since this recording of the transaction in a proprietary account may call into question the agency relationship, and it will have a sale of a covered debt security on its books and records.

As stated in Question 4 above, any member acting as agent in the sale of a covered debt security on behalf of a customer will be assessed a TAF for the customer sale. If however, a member is acting as agent on behalf of another member firm, the TAF will be assessed on the member that is the proprietary seller of the security, not the member acting as agent, provided that the member acting as agent does not record the transaction in any type of firm account which would result in a sale being recorded or reported on that member's books and records.

Question 8:

How will the TAF be applied to transactions with investment advisors that ultimately allocate the order among multiple customers?

As provided in *NTM 02-63*,[9] the TAF is assessed only on the initial execution of a transaction. Any related back office or clearing transactions that serve only to facilitate the clearance and settlement of a previously executed transaction are not assessed a TAF. For investment advisors that initially execute a large transaction that is later allocated among multiple customers, this means that only the initial execution that is reported to TRACE or the MSRB is subject to the TAF. Subsequent account allocations that do not represent reportable TRACE or MSRB transactions are not subject to the TAF.

Question 9:

How will the TAF apply to different types of short-term money market instruments (*i.e.*, corporate debt that at issuance has a maturity of one year or less is not TRACE eligible and not subject to the TAF, but there is no such exemption for short-term municipal securities)?

A member must determine whether a transaction in a short-term money market instrument is required to be reported under either TRACE or MSRB Rules. Based on the member's determination, the TAF will apply if the transaction is required to be trade reported to either TRACE or the MSRB.

Question 10:

Should rounding occur once at the end of each month on an aggregate basis, similar to how rounding occurs on the TAF calculation on equities?

Yes. Solely for purposes of submitting payment to NASD each month, each member's total aggregate payment due should be rounded to the nearest whole cent as is done for TAF calculations for equities, options, and futures.

Question 11:

For equities, there is a rule that says if the total proceeds of the trade are less than the TAF amount (calculated at rate x shares), then the TAF for the trade is zero. Does this rule also apply to fixed income?

Yes. If the execution price for a covered debt security is less than the TAF rate ($0.00075 for bonds) on a per bond transaction basis, then no fee will be assessed.

Covered Equity Securities Transactions

NASD is providing the following additional guidance with respect to covered equity security transactions based on questions received from member firms.

Question 12:

As a clearing firm, I receive transactions from my correspondents bundled together for clearing purposes, often referred to as "compressed" trades. I do not receive the individual components of these compressed clearing entries. Is it permissible to apply the TAF to the single compressed entry rather than the individual transactions that make up the compressed clearing entry?

No. As previously stated in *NTM 02-63*, Question 15, the TAF is applied to the initial execution of a transaction and not to any related clearing entries. The TAF must therefore be calculated based on the individual components of compressed clearing transactions. It is not permissible to apply the maximum transaction limit based on a compressed clearing entry. Clearing firms must have a mechanism in place that will allow them to identify the individual components of compressed clearing entries so that the TAF may be properly calculated based on the individual executions.

All Covered Securities Transactions

The following question applies to both covered debt and equity transactions.

Question 13:

Does the TAF apply to trades that are cancelled and subsequently corrected?

Yes. For a trade that is cancelled and later corrected, the TAF would apply to the corrected trade. If a cancelled trade, however, is not later corrected and re-billed, the TAF would not be assessed. Accordingly, corrected trades should be included in the firm's monthly aggregate transactions required to be reported on the monthly TAF Self-Reporting Form but cancelled trades that were not corrected should not be reported. Debt and equity trade corrections should be treated the same for the purposes of the TAF.

Endnotes

1 Securities Exchange Act Rel. No. 50485 (Oct. 1, 2004), 69 FR 60445 (Oct. 8, 2004) (File No. SR-NASD-2003-201) (Order of Approval).

2 Securities Exchange Act Rel. No. 49114 (Jan. 22, 2004), 69 FR 4194 (Jan. 28, 2004) (Notice of Filing of Proposed Rule Change).

3 *See* Letter to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, from Kathleen O'Mara, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD, dated September 30, 2004.

4 Securities Exchange Act Rel. No. 50485 (Oct. 1, 2004), 69 FR 60445 (Oct. 8, 2004) (File No. SR-NASD-2003-201).

5 Although reporting obligations are ultimately the responsibility of the member, the TAF, along with certain other NASD fees, has historically been assessed directly to the clearing firms (responsible for clearing the transaction on behalf of the member firm) and self-clearing member firms for operational reasons.

6 *See NTM 02-75*, Question 1.

7 *See Rule 6230*(c)(7).

8 *See* TRACE User Guide specifying how agency transactions are to be reported to TRACE.

9 *See NTM 02-63,* Question 15.

Trading Activity Fee Self-Reporting Form

NASD

Firm Name: ______________________

Mailing Address: ______________________ ◯ Check If New Address

____

B/D#: ______________________

Clearing#: ______________________

For the Month of: ______________________

Each member shall report sales of covered securities pursuant to the provisions of Section 1(b) [Trading Activity Fee] of Schedule A, Section 1 [Member Regulation Fees] to NASD's By-Laws. Covered securities include: 1) all exchange registered securities wherever executed (other than bonds, debentures, and other evidence of indebtedness); 2) all other equity securities traded otherwise than on an exchange; 3) all security futures wherever executed; 4) 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 (5) all municipal securities subject to MSRB reporting requirements.

Transaction Type	Aggregate Volume	Rate	Assessment Amount
1. Covered Equity Securities (under maximum)[1] - # of Shares		$ 0.000075	
2. Covered Equity Securities (at maximum)[1] - # of Trades		$ 3.75	
3. Covered Option Contracts		$ 0.002	
4. Covered Future Securities (# of Contracts Traded on a Round Turn Basis)		$ 0.04	
5. Covered Debt Securities (under maximum)[2] - # of Bonds		$ 0.00075	
6. Covered Debt Securities (at maximum)[2] - # of Trades		$ 0.75	
Total Assessment			

Signature of Authorized Representative ______________ Title ______________

Print Name ______________ Date/Telephone Number ______________

E-Mail Address ______________

Payment must be submitted with this form. The monthly form and payment are to be filed no later than 10 business days following the end of the month. The monthly form and payment may be submitted to NASD by either U.S. mail or overnight Express mail as follows:

For U.S. mail delivery:

NASD, P.O. Box 7777-W8555
Philadelphia, PA 19175-8555

Note: This P.O. Box will not accept courieror overnight deliveries.

For courier & overnight deliveries:

NASD, W8555 c/o Mellon Bank, Rm 3490
701 Market Street, Philadelphia, PA 19106

Phone number: 215-553-0697
(if required for the recipient)

For other payment methods:

Please call NASD Finance, at (240) 386-5394.

Questions regarding the Trading Activity Fee or the report should be directed to NASD Finance, at (240)386-5397.

1 There is a $3.75 maximum on covered equity securities. All volumes under the maximum of 50,000 shares must be reported as the aggregate number of shares on Line 1. Share volume for any transactions of 50,000 shares or more should be excluded from Line 1 and would be reported as the aggregate number of trades on Line 2.

2 There is a $0.75 maximum on covered debt securities. All volumes under the maximum of 1,000 bonds must be reported as the aggregate number of bonds on Line 5. Bond volume for any transactions of 1,000 bonds or more should be excluded from Line 5 and would be reported as the aggregate number of trades on Line 6.