

Notice to Members

SEPTEMBER 2005

SUGGESTED ROUTING

Legal and Compliance
Operations Managers
Senior Management

REQUEST FOR COMMENT

Trading Activity Fee

NASD Solicits Member Comment on Possible
Realignment of the Trading Activity Fee;
Comment Period Expires October 31, 2005

KEY TOPICS

NASD By-Laws
Trading Activity Fee

Executive Summary

NASD is issuing this *Notice to Members* to solicit comments from members on possible changes to the Trading Activity Fee (TAF). In 2003, the Securities and Exchange Commission (SEC or Commission) approved revisions to NASD By-Laws, eliminating the former regulatory fee assessed upon NASD members and instituting a new transaction-based TAF.¹ The TAF, along with other revenue components, funds NASD's member regulatory activities. Recently, questions have arisen regarding whether the TAF should be modified to ensure that NASD's member regulatory fees are distributed appropriately among the member firms that drive member regulatory costs. NASD seeks input from the membership on the impact of any potential realignment of the fee. Specifically, NASD is seeking feedback on the potential impact on member firms if the TAF were restructured to assess any customer transaction in a covered security, regardless of whether an NASD member firm is on the buy or sell side of the transaction, and all proprietary transactions not effected in a firm's capacity as a market maker. NASD is committed to seeking additional member input as it refines its analysis, and is committed to ensuring that any realignment be revenue neutral to NASD. Therefore, in conjunction with the proposed realignment, NASD will re-analyze the funding required for its member regulatory program in order to determine any further rate reduction as previously committed to reduce the percentage that the TAF contributes to the overall funding structure.

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.

Request for Comment

NASD encourages all members to comment on the proposed changes to the TAF. Comments must be received by **October 31, 2005**. Members and other interested parties can submit their comments using the following methods:

- ✦ **Mail** Attachment A to the address below;
- ✦ **Mail** comments in hard copy to the address below; or
- ✦ **E-mail** 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 Attachment A and one of the other methods listed above, he or she should indicate that in the submissions.

Attachment A is intended to offer a convenient way to participate in the comment process. It includes several specific questions that should be addressed, regardless of what method of comment is submitted. Furthermore, because the specific questions in Attachment A do not address all potential issues raised in this *Notice*, NASD encourages members using Attachment A to review the entire *Notice* and provide any additional written comments in Section 3 of Attachment A.

Attachment A and/or comments sent by hard copy should be mailed to:

Barbara Z. Sweeney
Office of the Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1506

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

Background and Discussion

In 2003, the SEC approved NASD's new member regulatory pricing structure, which: (1) eliminated the NASDAQ-based regulatory fee; (2) instituted a new transaction-based TAF applied across a broader range of equity, options and securities futures transactions; (3) increased the rates assessed to member firms under the Personnel Assessment (PA); and (4) implemented a simplified three-tiered flat rate for the Gross Income Assessment (GIA), whereby deductions and exclusions were eliminated.⁴ NASD uses fees collected under the member regulatory pricing structure to fund member regulatory activities, including the regulation of members through examination, processing of membership applications, financial monitoring, policymaking, rulemaking, and interpretive and enforcement activities. The changes to the regulatory pricing structure were designed to be revenue neutral to NASD and were intended to align NASD's regulatory fees with its regulatory functions, efforts and costs. Additionally, to minimize the impact on member firms, the restructuring of the fees was to be phased-in over a three-year period. As of 2005, the three-year phase-in for the GIA and PA are complete. Revenues generated from these fees have met expectations. One year of TAF rate reductions remains to be implemented, and separately, questions have been raised about whether restructuring of the scope of the TAF would better align that fee with NASD's costs.

Realignment of the Trading Activity Fee

NASD is seeking input from the membership on the fairness and feasibility of a potential TAF realignment. The primary issue that has been identified is that the TAF, a fee with the specific purpose of funding NASD's member regulatory efforts, is currently assessed for covered equity securities upon a class of transactions where there is no public customer involved in the transaction (*i.e.*, a market maker trading as principal with another broker-dealer), and not assessed on certain transactions that have direct customer involvement.⁵ As a result, TAF assessments are concentrated to a certain extent in a small number of member firms or business lines within member firms that may not be significant drivers of member regulatory expenses. Further, for covered equity securities, registered NASDAQ market makers have identified what they believe to be certain competitive disparities resulting from assessing the fee on market maker transactions occurring in the NASDAQ marketplace, but exempting transactions that occur on an exchange in a floor capacity. Presently, NASD provides an exemption for floor-based activity that occurs on an exchange, because these transactions do not result directly in an NASD registration requirement (many specialists and other floor traders are NASD-registered for other reasons). NASDAQ market makers, however, do not get the benefit of this TAF exemption.

As noted, NASD is analyzing whether to assess the TAF on all buy and sell transactions where a member trades as principal or riskless principal with a customer or acts as agent on behalf of a customer; and on all principal transactions with another broker-dealer not effected in a member's capacity as a registered market maker, exempting trades between a market maker in its market making capacity with another broker-dealer. In short, the contemplated changes to the scope of the TAF would spread the fee over a wider group of NASD members, re-distributing the fee in part from firms or business lines within firms that execute large numbers of transactions to firms or business lines within firms that deal directly with customers or trade proprietarily. As NASD proceeds with its analysis, it seeks member comment on whether a realignment is equitable, whether the proposed changes in scope would achieve the proposed re-distribution and whether such changes would require substantial re-programming of member firm systems.

Rate Reduction for the Trading Activity Fee

In order to ensure a member regulatory pricing structure that is revenue neutral to NASD, NASD management committed to a periodic analysis of rates, volumes and regulatory responsibilities to ensure adequate funding levels for its member regulatory programs. Further, as part of the three-year phase-in plan included in the proposed pricing structure, NASD stated its intent to reduce the percentage that the TAF contributes to the overall funding structure in 2004 and again in 2005 by increasing the percentage funded by the PA. In conjunction with the proposed realignment, NASD will re-analyze revenues and expenses to determine the appropriate rate reduction needed in order to reduce the share of the member regulatory program funded by transaction activity.

Endnotes

- 1 Securities Exchange Act Rel. No. 47946 (May 30, 2003) , 68 FR 34021 (June 6, 2003) (approving SR-NASD-2002-148).
- 2 See *Notice to Members 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 Securities Exchange Act of 1934 (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 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).
- 5 See *Notice to Members 02-63*, Question 14, which states that riskless principal transactions reported correctly will be viewed as one transaction for purposes of assessing the TAF. Because the TAF is applied in a manner consistent with Section 31 of the Exchange Act and Rule 31 thereunder, this results in the first leg of a riskless principal transaction being assessed while the second leg of the transaction with the customer being exempt from the fee.

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ATTACHMENT A

Proposed Change to TAF and Related Financial Impact

1. Do you support assessing the TAF on all buy and sell transactions effected with a public customer, as principal, riskless principal or agent; and on all proprietary transactions not effected in a member's capacity as a market maker?

☐ Yes ☐ No

Please provide a written statement addressing your firm's position below.

2. Will such a proposed change require significant programming efforts on your firm's behalf?

☐ Yes ☐ No

Please explain your answer below and include an estimate of the necessary time frame required to implement such a change.

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3. Please comment below on any additional issues your firm would like to address regarding this *Notice*.

Contact Information

Name:

Firm:

Clearing #:

Address:

City/State/Zip:

Phone:

E-Mail:
