

# Notice to Members

AUGUST 2006

## SUGGESTED ROUTING

Legal & Compliance  
Registered Representatives  
Senior Management  
Trading

## KEY TOPICS

NASDAQ Exchange Registration  
Trading Activity Fee

## GUIDANCE

### Trading Activity Fee

Exemption for Registered NASDAQ Market Makers  
Acting in the Capacity of Exchange Market Maker

#### Executive Summary

NASD is issuing this *Notice* to supersede *NASD Notice to Members (NTM) 06-37* and replace the guidance provided in that *Notice* relating to the application of the Trading Activity Fee (TAF) to members acting in the capacity of an exchange specialist or market maker. Accordingly, this *Notice* repeats pertinent information from *NTM 06-37*. However, it also provides additional guidance and clarification not included in *NTM 06-37*.

On July 5, 2006, NASDAQ announced that it would begin to operate as a national securities exchange on August 1, 2006 for NASDAQ-listed securities.<sup>1</sup> Section 1 of Schedule A to NASD's By-Laws exempts from the TAF 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, and that is subject to Securities Exchange Act of 1934, Section 11(a) and Rule 11a1-1(T)(a) thereunder. The exemption does not, however, apply to other transactions permitted by Section 11(a), such as *bona fide* arbitrage or hedge transactions.

Accordingly, on August 1, 2006 when NASDAQ became operational as an exchange in NASDAQ securities, NASD member firms that are also members of the NASDAQ Exchange became exempt from the TAF for transactions in which they act in their capacity as a registered market maker in such NASDAQ securities.<sup>2</sup> Further, when NASDAQ becomes operational as an exchange in Consolidated Quotation System (CQS) securities on approximately October 1, 2006, NASD member firms that are also members of the NASDAQ Exchange will be exempt from the TAF for transactions effected on the NASDAQ Exchange in which they act in their capacity as a registered market maker in CQS securities.

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## Questions/Further Information

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

## 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.<sup>3</sup> 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.

As stated above, Section 1 of Schedule A to NASD's By-Laws exempts from the TAF 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, and that is subject to Securities Exchange Act of 1934, Section 11(a) and Rule 11a1-1(T)(a) thereunder. Accordingly, once NASDAQ is operational as an exchange, this exemption will be applicable to transactions that occur on the NASDAQ Exchange in the same manner as it is currently applicable to certain transactions that occur on other exchanges. To assist members in understanding the application of this exemption to market making activity on the NASDAQ Exchange, NASD staff is publishing the following questions and answers.

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## Questions and Answers

1. **Will a member be exempt for all proprietary transactions in NASDAQ-listed securities for which it is registered as a market maker?**

No. Only those proprietary transactions effected through the registered market maker's attributable quote on the NASDAQ Exchange are exempt from the TAF. Proprietary transactions of a registered market maker executed through SIZE on the NASDAQ Exchange are not exempt from the TAF, as well as transactions not effected through the NASDAQ Exchange like, for example, those reported to either a Trade Reporting Facility (TRF)<sup>4</sup> or the Alternative Display Facility (ADF).<sup>5</sup>

2. **Does the exemption relating to registered NASDAQ Exchange market makers apply only to NASDAQ-listed securities?**

Yes. Until NASDAQ is operational as an exchange in all National Market System (NMS) securities, the TAF exemption will apply only to NASDAQ-listed securities.<sup>6</sup> NASDAQ has announced that it intends to be operational as an exchange in CQS securities on October 1, 2006. Accordingly, until NASDAQ is operating as a national securities exchange in CQS securities, transactions executed through NASDAQ systems in CQS securities are still subject to the TAF. At such time that NASDAQ is operational as an exchange in CQS securities, the TAF exemption discussed above for registered market makers acting in their capacity as a registered market maker on the NASDAQ exchange will also be applicable to CQS securities.

3. **If I am a registered market maker on the NASDAQ Exchange and receive an agency order from an NASD member broker-dealer that I then send to the NASDAQ Exchange for execution, is that transaction exempt from the TAF?**

Yes. Consistent with guidance issued in *Notice to Members 02-75*, Question 3, when a member acts as agent on behalf of another NASD member in the sale of a covered security, the fee will be assessed to the member who is the ultimate seller of the security, not the member acting as agent. Therefore, an agency transaction executed on behalf of another NASD member broker-dealer on the NASDAQ Exchange by a registered market maker acting in such capacity is exempt from the TAF.

4. **If I am a registered market maker on the NASDAQ Exchange and receive an order from a customer that I send to the NASDAQ Exchange for execution, is that transaction exempt from the TAF?**

No. Transactions executed on behalf of a registered market maker's own customer, including agency and riskless principal transactions, must be assessed the TAF.

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5. If I am a registered market maker on the NASDAQ Exchange and place an order in SIZE that is subsequently executed, is that transaction exempt from the TAF?

No. An execution resulting from an order, either agency or principal, placed into SIZE is not exempt from the TAF.

6. If I am a registered market maker and enter an attributable proprietary market making order or quote into the NASDAQ Market Center that is immediately executed (*i.e.*, does not become displayed on NASDAQ's book since it was marketable upon receipt), is the resulting execution exempt from the TAF?

Yes. Executions resulting from attributable proprietary orders or quotes entered by a registered market maker acting in the capacity of an exchange market maker are exempt from the TAF. Proprietary transactions that are not related to market making activities are not exempt from the TAF, even if executed by or through a registered market maker's MPID or account.

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## Endnotes

- 1 The Securities and Exchange Commission (SEC) approved NASDAQ's application for registration as a national securities exchange on January 23, 2006. See Exchange Act Release No. 53128 (Jan. 13, 2006), 71 FR 3550 (Jan. 23, 2006) (File No. 10-131). On June 30, 2006, the SEC issued an order modifying a condition to NASDAQ's operation as a national securities exchange. See Exchange Act Release No. 54085 (June 30, 2006), 71 FR 38910 (July 10, 2006) (File No. 10-131). NASDAQ plans to be operational as an exchange in NASDAQ-listed issues on August 1, 2006, and in other exchange-listed issues on or after September 1, 2006. See NASDAQ Head Trader Alert No. 2006-098 (July 5, 2006), [www.nasdaqtrader.com/trader/news/2006/headtraderalerts/hta2006-098.stm](http://www.nasdaqtrader.com/trader/news/2006/headtraderalerts/hta2006-098.stm) and NASDAQ Head Trader Alert No. 2006-111 (July 26, 2006), [www.nasdaqtrader.com/Trader/News/2006/headtraderalerts/hta2006-111.stm](http://www.nasdaqtrader.com/Trader/News/2006/headtraderalerts/hta2006-111.stm).
- 2 See, e.g. *Notice to Member 02-63* (Sept. 2002), Question 1.
- 3 See Exchange Act Release No. 47946 (May 30, 2003), 68 FR 34021 (June 6, 2003) (approving SR-NASD-2002-148) and Exchange Act Release No. 47106 (Dec. 30, 2002), 68 FR 819 (Jan. 7, 2003) (approving SR-NASD-2002-99).
- 4 See Exchange Act Release No. 54084 (June 30, 2006), 71 FR 38935 (July 10, 2006) (File No. SR-NASD-2005-087) (SEC approval of the changes to NASD rules to reflect NASDAQ's registration as an exchange and the operation of the TRF by NASDAQ subject to NASD's regulatory license and oversight).
- 5 See Exchange Act Release No. 46249 (July 24, 2002), 67 FR 49822 (July 31, 2002) (SEC approval of SR-NASD-2002-97 authorizing NASD to operate the ADF on a pilot basis); Exchange Act Release No. 47633 (Apr. 10, 2003), 68 FR 19043 (Apr. 17, 2003) (File No. SR-NASD-2003-067) (extension of ADF pilot until January 26, 2004); Exchange Act Release No. 49131 (Jan. 27, 2004), 69 FR 5229 (Feb. 3, 2004) (File No. SR-NASD-2004-012) (extension of ADF pilot until October 26, 2004); Exchange Act Release No. 50601 (Oct. 28, 2004), 69 FR 64611 (Nov. 5, 2004) (File No. SR-NASD-2004-160) (extension of ADF pilot until July 26, 2005); Exchange Act Release No. 52122 (July 25, 2005), 70 FR (Aug. 1, 2005) (File No. SRNASD-2005-092) (extension of ADF pilot until April 26, 2006); Exchange Act Release No. 53699 (April 21, 2006), 71 FR 25271 (Apr. 28, 2006) (File No. SR-NASD-2006-050) (extension of ADF pilot period until January 26, 2007).
- 6 See Exchange Act Release No. 51808 (June 5, 2005), 70 FR 37496 (June 29, 2005) (File No. S7-10-04) (SEC order adopting rules under Regulation NMS and amendments to the joint industry plans for disseminating market information).

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