

March 18, 2003

Ms. Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: File No. SR-NASD-2002-148 – Proposed Rule Change to By-Laws Regarding the Regulatory Fee and the SEC Section 31 Transaction Fee; Response to Comments and Amendment No. 3

Dear Ms. England:

NASD hereby responds to the comment letters received by the Securities and Exchange Commission (“Commission” or “SEC”) in response to the publication in the *Federal Register* of Notice of Filing of SR-NASD-2002-148, regarding proposed changes to NASD’s member regulatory pricing structure.¹ In addition, because the Trading Activity Fee (“TAF”) originally was filed for immediate effectiveness in SR-NASD-2002-98, NASD is responding to all comments submitted in connection with SR-NASD-2002-98.² Furthermore, in response to the comment letters, NASD is submitting Amendment No. 3 to the rule proposal.

I. Background

On July 24, 2002, NASD filed with the SEC a proposal to amend its member regulatory pricing structure.³ Under the structure in place at the time, three types of fees and assessments were used to fund NASD’s member regulatory activities: Regulatory Fee, Personnel Assessment, and Gross Income Assessment (“GIA”). The restructuring, as proposed, has four components: (1) elimination of the Regulatory Fee; (2) institution of a new transaction-based Trading Activity Fee similar in scope to the SEC’s Section 31 Fee; (3) an increase to the rates assessed to member firms under the Personnel Assessment; and (4) implementation of a simplified three-tiered flat rate for the GIA.⁴ SR-NASD-2002-98 was part of a package of two

¹ Securities Exchange Act Rel. No. 46817 (Nov. 12, 2002), 67 FR 69784 (Nov. 19, 2002).

² Securities Exchange Act Rel. No. 46416 (Aug. 23, 2002), 67 FR 55901 (Aug. 30, 2002).

³ As stated in the rule filings, NASD’s regulatory functions include performing examinations, processing of membership applications, financial monitoring, and policy, rulemaking, interpretive, and enforcement activities.

⁴ The changes resulting from the proposed restructuring would be revenue neutral to NASD.

separate yet related rule filings⁵ submitted to the SEC as a result of a review of the overall NASD pricing structure and was intended to address the first two amendments to NASD's pricing restructuring by eliminating the Regulatory Fee and instituting a new transaction-based Trading Activity Fee.

The SEC published the TAF rule change submitted in SR-NASD-2002-98 in the *Federal Register* on August 30, 2002. Six comment letters were submitted that addressed the TAF.⁶ In response to comments received on the TAF, NASD subsequently filed two proposed rule changes with the SEC relating to SR-NASD-2002-98. As noted above, the initial TAF proposal (SR-NASD-2002-98) was filed for immediate effectiveness pursuant to Section 19(b)(3)(A)(ii) of the Securities Exchange Act of 1934 ("Act")⁷ and Rule 19b-4(f)(2) thereunder,⁸ and went into effect on October 1, 2002. The first subsequent rule filing, SR-NASD-2002-147, established a sunset provision terminating on December 31, 2002 the changes made to Schedule A to NASD By-Laws by SR-NASD-2002-98. The second rule filing, SR-NASD-2002-148, contained substantially the same rule language as proposed in SR-NASD-2002-98, but was submitted pursuant to Section 19(b)(2) of the Act to allow for an additional notice and comment period per the commenters' requests. On November 7, 2002, NASD submitted an amendment to SR-NASD-2002-148 that revised the TAF rates in response to members' comments to incorporate a per trade maximum. To date, the SEC has received nine comment letters in response to SR-NASD-2002-148.⁹

With the sunset provision for the TAF due to expire on December 31, 2002, NASD determined not to revert to the previous pricing structure established in Section 8 of Schedule A to NASD By-Laws, but rather to extend the TAF pilot program until March 1, 2003. On December 24, 2002, NASD filed SR-NASD-2002-182 to extend the proposed TAF structure until March 1, 2003.¹⁰ On February 28, 2003, NASD further extended the TAF pilot program

⁵ See also SR-NASD-2002-99, Proposed Rule Change to By-Laws Regarding Gross Income Assessment and Personnel Fee. The SEC approved SR-NASD-2002-99 on Dec. 30, 2002. See Securities Exchange Act Rel. No. 47106 (Dec. 30, 2002), 68 FR 819 (Jan. 7, 2003).

⁶ Letter from Philadelphia Stock Exchange dated Sept. 17, 2002 ("PHLX letter"); Letter from Chicago Board Options Exchange, Inc. dated Sept. 18, 2002 ("CBOE letter"); Letter from CBOE, The Options Clearing Corporation ("OCC"), International Securities Exchange, Inc. ("ISE"), the Pacific Exchange, Inc. ("PCX"), and PHLX dated Sept. 20, 2002 ("Joint Exchange letter"); Letter from Securities Industry Association dated Sept. 26, 2002 ("SIA letter"); Letter from the Cincinnati Stock Exchange dated Sept. 27, 2002 ("CSE letter"); and Letter from TD Securities dated Oct. 21, 2002 ("TD Sec. letter").

⁷ 15 U.S.C. § 78s(b)(3)(A)(ii).

⁸ 17 CFR § 240.19b-4(f)(2).

⁹ Letter from CBOE, OCC, ISE, PCX, and PHLX dated Dec. 5, 2002 ("Joint Exchange letter"); Letter from CBOE dated Dec. 6, 2002 ("CBOE letter"); Letter from TD Sec. dated Dec. 6, 2002 ("TD Sec. letter"); Letter from Raymond James Financial, Inc. dated Dec. 9, 2002 ("Raymond James letter"); Letter from SIA dated Dec. 9, 2002 ("SIA letter"); Letter from Susquehanna International Group, LLP. dated Dec. 10, 2002 ("SIG letter"); Letter from CSE dated Dec. 10, 2002 ("CSE letter"); Letter from The New York Stock Exchange, Inc. dated Dec. 11, 2002 ("NYSE letter"); and Letter from Securities Traders Association dated Jan. 23, 2003 ("STA letter").

¹⁰ The SEC approved this rule change on December 31, 2002. See Securities Exchange Act Rel. No. 47112 (Dec.

until April 1, 2003.¹¹ Today, NASD formally responds to all comments received in connection with NASD's TAF proposals (SR-NASD-2002-98 and SR-NASD-2002-148). In addition, NASD is submitting Amendment No. 3 to the rule proposal. Furthermore, NASD is requesting that the SEC approve SR-NASD-2002-148, thereby approving the TAF on a permanent basis, prior to expiration of the TAF pilot program on April 1, 2003. If the TAF is not approved, upon expiration of the pilot program, this portion of the member regulatory pricing structure will revert back to Section 8 of Schedule A to NASD By-Laws.

II. Response to Comments

A. Proposed Fees Are Anti-Competitive, Unfair, and Inequitable

1. Fees Constitute Anti-Competitive Subsidization of the Nasdaq Stock Market, Inc. ("NASDAQ")

Six commenters argued that the proposed TAF is anti-competitive because it favors NASDAQ in some manner or adversely impacts other markets by shifting regulatory costs to markets unregulated by NASD.¹² For example, one commenter asserted that "NASD intends to use its status so that NASDAQ may gain a competitive advantage by forcing members to refrain from trading on competing markets."¹³ Specifically, the commenter asserted that the TAF is being "implemented to recapture revenues lost (both transaction fee and market data revenue) by NASD due to competition [R]ather than have NASDAQ compete on level terms with other markets, NASD is proposing to assert claim over lost transactions to mitigate losses and remain revenue neutral."¹⁴ Another commenter stated: "NASD proposes to impose regulation-related costs to fill a shortfall caused by competitively induced market share loss."¹⁵ Similarly, two commenters noted that "fees of this nature could be used as a competitive tool."¹⁶

The anti-competitive concerns cited by these commenters are not well placed. Commenters' observation that the TAF places NASDAQ at a competitive advantage demonstrates a lack of understanding of the NASD-NASDAQ structure and the regulatory responsibilities of NASD. NASD uses funds collected through the TAF solely to fund the regulation of NASD members' activity in areas such as sales practices, routine examinations, financial and operational reviews, new member applications, enforcement and other conduct within NASD's jurisdiction. NASD has responsibility for its members' activity regardless of

31, 2002), 68 FR 824 (Jan. 7, 2003).

¹¹ SR-NASD-2003-26 (February 28, 2003).

¹² PHLX letter dated Sept. 17, 2002; CSE letters dated Sept. 27, 2002 and Dec. 10, 2002; CBOE letter dated Dec. 6, 2002; SIG letter dated Dec. 10, 2002; NYSE letter dated Dec. 11, 2002; and STA letter dated Jan. 23, 2003.

¹³ CSE letter dated Sept. 27, 2002.

¹⁴ CSE letter dated Dec. 10, 2002.

¹⁵ NYSE letter dated Dec. 11, 2002.

¹⁶ CBOE letter dated Dec. 6, 2002 and SIG letter dated Dec. 10, 2002.

where such activity occurs. These revenues will not fund the regulation of NASDAQ. NASDAQ will not receive any subsidization either directly or indirectly based on these fees. All NASDAQ regulatory activities provided by NASD are fully funded by NASDAQ through its own revenue structure. As such, comments that articulate a concern that this fee is designed to recoup lost NASDAQ revenues are baseless. In fact, the existing pricing structure, which used NASDAQ trading activity to fund clearly non-NASDAQ member conduct regulatory activity, placed NASDAQ at a significant competitive disadvantage. Eliminating part of that competitive disadvantage should not be confused with creating an anti-competitive advantage.

2. Fees Are Unfair And Inequitable

Several commenters argued that NASD's TAF is unfair and inequitably structured.¹⁷ These commenters' concerns focused on the scope of the securities transactions covered by the TAF. For example, the Joint Exchange letter questioned NASD's "decision to limit the coverage of the TAF to transactions covered by Section 31," claiming that this "appears to undermine fatally the statutory requirement of equitable allocation of fees."¹⁸ These commenters argued that it was unfair to exclude products such as debt securities, mutual funds, and variable annuities from the TAF because NASD provides regulatory services for these products.¹⁹ Further, four commenters stated that the TAF should not be assessed on listed options transactions because NASD has limited regulatory responsibility over these securities.²⁰ These commenters also asserted that NASD's regulatory responsibilities for listed options have decreased since the SEC approved the plan allocating responsibilities for options sales practices among AMEX, CBOE, ISE, NYSE, PHLX, PSE, and NASD. Accordingly, these commenters requested that listed options be exempted from the TAF.

NASD strongly disagrees with commenters that characterize the TAF as unfair and inequitable. NASD's goal in establishing this fee structure was to create a simplified structure for recovering its regulatory costs. The scope of the TAF mirrored the SEC's Section 31 Fee in part to minimize programming impact on firms. Accordingly, debt, mutual funds, and variable annuities were excluded from the scope. NASD further notes that mutual funds and variable annuities do not have transaction reporting schemes, making a transaction-based fee based on this activity extremely difficult to apply consistently and fairly. NASD also set its Personnel Assessment and GIA rates at a level designed to ensure that regulatory expense levels for these types of products were fully and fairly funded. Because transaction reporting for debt is new, and in an effort to minimize member firms' programming efforts, NASD did not vary from Section 31 to include these transactions. Although NASD strongly believes that the statutory requirement for fees is not so specific as to require inclusion of debt transactions to pass statutory

¹⁷ Joint Exchange letter dated Sept. 20, 2002; PHLX letter dated Sept. 17, 2002; CBOE letter dated Dec. 6, 2002; TD Sec. letter dated Dec. 6, 2002; and SIG letter dated Dec. 10, 2002.

¹⁸ Joint Exchange letter dated Sept. 20, 2002.

¹⁹ Joint Exchange letter dated Dec. 5, 2002.

²⁰ Joint Exchange letter dated Dec. 5, 2002; SIG letter dated Dec. 10, 2002; CSE letter dated Dec. 10, 2002; and STA letter dated Jan. 23, 2003.

muster, NASD commits to examine these markets when considering further modifications to its funding structure.

NASD also disagrees with commenters' suggestions that listed options should not be assessed under the TAF. Although it is true that changes to the allocation plan have reduced NASD's responsibilities in this area, NASD continues to assume the largest share of options self-regulatory allocation through the Options Self-Regulatory Council. NASD's current costs relating to options regulation far exceed the anticipated revenue it will receive from this portion of the TAF.²¹ Importantly, this analysis excludes options sales practice work performed for other self-regulatory organizations ("SROs"), which is separately funded by individual contract. NASD clearly has the right, and obligation, to fund those regulatory activities in as fair a manner as possible.

B. No Clear Nexus Between Proposed Fees and NASD's Regulatory Services

Seven commenters criticized the TAF because of the view that it imposes fees on transactions that have no regulatory nexus to NASD.²² In addition, seven commenters asserted that the rules are in violation of SEC's well-established policy relating to the imposition of regulatory fees, which requires that SRO fees be related to the regulatory responsibilities being funded.²³ Five commenters expressed concern that allowing NASD to collect these fees would set a precedent for other SROs to implement similar fees.²⁴

These criticisms, whether of the options portion of the TAF or the TAF in general, are based on the incorrect assumption that trading activity by NASD members has no impact on NASD's member regulatory obligations. All conduct, including options, equities, and derivatives trading activity within a registered broker/dealer, drives some level of member regulatory effort, whether it is sales practice, financial surveillance, anti-fraud enforcement, supervision, or other requirements. As stated in SR-NASD-2002-98 and SR-NASD-2002-148, the costs to regulate member firms include funding for examinations, processing of membership applications, financial monitoring, policy, rule making, interpretive and enforcement activities. These are member and self-regulatory obligations that exist separate and apart from any market-specific rules and obligations. The fact that other SROs regulate conduct on their markets does

²¹ The same is true for the equities and securities futures portions of the TAF. The revenues from these products cover a small subset of NASD's member regulatory expenses. Particularly in the options and securities futures areas, where regulatory expenses are somewhat discrete, NASD intends to monitor costs and revenues to ensure that the revenues do not exceed the costs and serve as a cross-subsidy of other portions of the member regulatory program.

²² PHLX letter dated Sept. 17, 2002; CBOE letters dated Sept. 18, 2002 and Dec. 6, 2002; Joint Exchange letter dated Sept. 20, 2002; CSE letter dated Sept. 27, 2002; TD Sec. letters dated Oct. 21, 2002 and Dec. 6, 2002; SIG letter dated Dec. 10, 2002; NYSE letter dated Dec. 11, 2002; and STA letter dated Jan. 23, 2003.

²³ NYSE letter dated Dec. 11, 2002; PHLX letter dated Sept. 17, 2002; CBOE letters dated Sept. 18, 2002 and Dec. 6, 2002; Joint Exchange letter dated Sept. 20, 2002; CSE letters dated Sept. 27, 2002 and Dec. 10, 2002; TD Sec. letter dated Dec. 6, 2002; and SIG letter dated Dec. 10, 2002.

²⁴ CBOE letter dated Sept. 18, 2002; SIA letters dated Sept. 26, 2002 and Dec. 6, 2002; TD Sec. letters dated Oct. 21, 2002 and Dec. 6, 2002; SIG letter dated Dec. 10, 2002; and STA letter dated Jan. 23, 2003.

not eliminate NASD's responsibility to regulate its members' activity, both trading and non-trading related. The nexus between the TAF and the regulatory programs specifically defined above therefore is clear. NASD also has taken necessary steps specifically to exclude that class of transactions that may lack a direct nexus to its regulatory responsibilities. Transactions that are defined as marketplace-specific floor transactions²⁵ are exempt from the TAF. To argue that the remaining transactions, which directly or indirectly involve the member-customer relationship, have no nexus to the regulatory responsibilities of NASD, reflects a lack of understanding of the NASD mandate.

With respect to concerns expressed by commenters that other markets may implement fees similar to NASD's fees, NASD reiterates that these fees are related directly to its responsibilities. If other SROs are able to demonstrate that their member regulatory obligations extend outside the markets to which they are affiliated, it would not be inappropriate to fund their regulatory programs in a similar manner. NASD of course is not fully informed about the regulatory expense and structure of other SROs. However, it assumes that member regulation unrelated to affiliated markets assumes a smaller portion of the regulatory budgets of other SROs than for NASD. It would therefore be very difficult for another SRO to link regulatory responsibilities (and attendant fees) to activity away from its affiliated market.

That said, NASD believes that the breadth of its mandate as the primary member regulator for the broker/dealer industry, the level of separation between its regulatory subsidiary and the markets within its organization, and the size and heterogeneity of its membership make it, and its funding needs, unique among SROs. Because NASD's member regulatory responsibilities are unrelated to membership or activity in any specific marketplace, NASD has little difficulty demonstrating that trading activity by its members away from any affiliated market has a nexus to its regulatory obligations.

C. NASD Improperly Filed the Initial TAF Proposal For Immediate Effectiveness And Failed to Respond to Comment Letters

Several commenters expressed concern because NASD filed the initial TAF proposal for immediate effectiveness.²⁶ Commenters noted that member firms were not given an opportunity to express their views prior to the new fee becoming effective. In addition, the SIA asserted that more time was needed to provide comments on the TAF proposal and how it interrelates with the GIA and Personnel Assessment, as well as the regulatory fees of other SROs.²⁷ In addition, two commenters believed that the TAF was imposed too swiftly, with inadequate time to make the requisite programming changes.²⁸ These commenters asserted that the TAF became effective

²⁵ As stated in *Notice to Members 02-63*, proprietary transactions by a jointly registered NASD member, in its capacity as an exchange specialist or market maker, that are subject to SEC Section 11(a) and SEC Rule 11a1-1(T)(a) thereunder, are excluded from the scope of the TAF. However, other transactions, such as bona fide arbitrage or hedge transactions involving a long or short position in an equity security, are subject to the TAF.

²⁶ SIA letters dated Sept. 26, 2002 and Dec. 9, 2002; CSE letter dated Sept. 27, 2002; and Raymond James letter dated Dec. 9, 2002.

²⁷ SIA letters dated Sept. 26, 2002 and Dec. 9, 2002.

²⁸ SIA letters dated Sept. 26, 2002 and Dec. 9, 2002 and Raymond James letter dated Dec. 9, 2002.

before firms were able to sufficiently program and test the necessary system changes. In addition, three commenters stated that they believed that NASD has not responded to the procedural and substantive concerns raised in response to SR-NASD-2002-98.²⁹ Similarly, another commenter asserted that SR-NASD-2002-148 is deficient on its face because it does not discuss comments received in connection with SR-NASD-2002-98.³⁰

NASD initially filed SR-NASD-2002-98 for immediate effectiveness for several reasons: (1) the separation of NASD from NASDAQ necessitated that NASD move away from assessing fees based on the ACT system, which is a NASDAQ proprietary system; (2) the TAF would result in a fee reduction for members; (3) members had the opportunity to comment on pricing in response to *Notice to Members 02-09*; and (4) NASD staff worked closely with the industry and the SEC in formulating the fee structure and resolving interpretive questions. NASD notes that it received 16 comment letters in response to SR-NASD-2002-98 and SR-NASD-2002-99. Procedurally, NASD responded to the concern raised in these comments that the filing should not have been filed for immediate effectiveness by filing SR-NASD-2002-147 sunsetting the original filing and refiling the TAF proposal in SR-NASD-2002-148 to provide for an additional notice and comment period. Members had the ability to submit another comment letter in connection with the TAF proposal; in fact, several commenters submitted two comment letters: one in response to SR-NASD-2002-98 and a second in response to SR-NASD-2002-148. In addition, NASD established the TAF rates and published them as amendments to these filings.³¹ NASD also worked closely with numerous large clearing firms and third party vendors prior to the effective date and received indications from these clearing firms and vendors that they would be ready for an October 1, 2002 effective date. NASD moved the originally scheduled September 1 effective date back to October 1 to accommodate system programming time and delayed the first remittance date until January 15, 2003 to further accommodate members' system programming requirements.

Moreover, NASD was not required to discuss comments filed in connection with SR-NASD-2002-98 when filing a completely new rule filing, SR-NASD-2002-148. However, while a response to comments is not required in connection with SR-NASD-2002-98, because it was filed for immediate effectiveness, NASD nonetheless is responding to all comments received regarding the TAF, including those raised in connection with SR-NASD-2002-98 and SR-NASD-2002-148.

D. NASD Provides Insufficient Financial Analysis

Four commenters asserted that NASD did not provide an explanation of the amount of revenue the TAF is expected to generate, the regulatory activities the fee is expected to support, or an analysis of the different fee rates for equities, options, or securities futures.³² One

²⁹ Joint Exchange letter dated Dec. 5, 2002; CBOE letter dated Dec. 6, 2002; and SIG letter dated Dec. 10, 2002.

³⁰ Joint Exchange letter dated Dec. 5, 2002.

³¹ See Securities Exchange Act Rel. No. 46817, 67 FR 69785 (Nov. 19, 2002).

³² Joint Exchange letter dated Dec. 5, 2002; SIA letter dated Dec. 9, 2002; CSE letter dated Dec. 10, 2002; and NYSE letter dated Dec. 11, 2002.

commenter stated that NASD should have been required to provide in more detail a fair and reasonable basis for expanding the TAF such as accompanying the filing with data on volume assumptions and/or rates showing that NASD conducted a financial analysis.³³ Other commenters demanded that NASD analyze regulatory costs for specific securities products and the revenue generated on this activity by the TAF.³⁴ For example, one commenter requested “specific details on the options activity the TAF is intended to cover and how the funds it proposes to collect for options activity will be used.”³⁵ This same commenter also argued that NASD’s collection of fees for options trading be limited to the recovery of its costs in regulating listed options activity. In addition, two commenters asserted that NASD has changed the TAF rate three times in less than three months with virtually no explanation, thereby making the TAF rate appear arbitrary or based on political considerations rather than on a rigorous analysis of NASD’s regulatory costs.³⁶

NASD has provided SEC staff with an overview of NASD’s costs and the revenues it anticipates the fee structure generating, and NASD has specified in its filing what regulatory activities the fee supports. Furthermore, the statutory requirement that fees be reasonable and equitably allocated does not require a pricing structure so specific and complex as to tie specific self-regulatory programs and related expenses to specific business lines within a firm. Nonetheless, even if NASD were required to examine costs and revenue to this level of specificity, NASD believes the proposed fee structure is appropriate. NASD emphasizes that the scope of regulatory burden associated with rulemaking, investigation, and enforcement associated with its members’ compliance with sales practice and business conduct requirements is a function of the aggregate member activities in all regulated products; it is inexact and perhaps misleading to attempt to parcel out NASD costs solely on a transaction-by-transaction, product-by-product basis. As noted in the original filing, NASD believes that trading activity of members, in combination with total revenues of a broker/dealer member and the number of registered persons, serves as an effective proxy for what drives NASD’s member regulatory costs.

NASD believes that the scope of its regulatory activities and costs has remained consistent. NASD was required to make an initial estimate of applicable volume to establish the TAF rates. NASD later adjusted the rate in response to member feedback and further analysis of volumes. The rates were adjusted to ensure the fee is reasonable and fairly allocated. Moreover, because the member regulatory fee structure is to remain revenue neutral to NASD, it is anticipated that the TAF rate will be adjusted periodically.

³³ SIA letter dated Dec. 9, 2002.

³⁴ Joint Exchange letter dated Dec. 5, 2002 and TD Sec. letter dated Dec. 6, 2002.

³⁵ TD Sec. letter dated Dec. 6, 2002.

³⁶ Joint Exchange letter dated Dec. 5, 2002 and TD Sec. letter dated Dec. 6, 2002.

E. The Filing Does Not Codify the Exemptions Provided in the Notices to Members

Five commenters stated that the filing does not codify the exemptions to the TAF provided in *Notices to Members 02-63 and 02-75*.³⁷ Specifically, four commenters³⁸ argued that NASD should codify the exemption set forth in *Notice to Members 02-75*, stating that the TAF will not be assessed on transactions for non-member broker/dealers that clear through an NASD member broker/dealer, unless the NASD member clearing firm also acts as the executing broker in a transaction. According to these commenters, this exemption is necessary because options market makers that are not NASD members should not have to pay for their options transactions solely because they clear through an NASD member. In addition, three commenters assert that the exemption in *Notice to Members 02-63* that stated that transactions effected on a national securities exchange by a dually registered specialist or floor based market maker will not be covered by the TAF should be incorporated into the text of the rule.³⁹ These commenters believe that without at least an interpretation regarding these exemptions in the rule text, “nothing would preclude the NASD from revoking [them] at any time.” Another commenter stated that NASD should not have retained exemptive authority within the TAF rule because this exemptive authority will allow NASD to “arbitrarily apply the fees to certain members while exempting others,” and that Section 2(b)(2) of Schedule A to NASD By-Laws as amended is a “catchall [that] leaves much discretion to NASD without need for Commission approval.”⁴⁰

The TAF is an assessment on NASD members; it is never assessed on non-members. In response to commenters’ concerns that certain exemptions discussed in *Notice to Members 02-63 and 02-75* could be revoked or modified, NASD is amending the rule filing to incorporate existing interpretations into the text of the rule.⁴¹ In addition, NASD agrees that substantive changes to its funding mechanisms are best made through a consultation with the membership, and intends to use its exemptive authority sparingly and only to interpret existing requirements.

III. Amendments to the Rule Filing

NASD believes that the foregoing fully responds to material issues raised by commenters. In response to comments identified above, and upon further consideration of the rule filing, NASD hereby amends the rule filing as follows (deleted text from the proposal is bracketed; new text is underlined):

* * * * *

³⁷ Joint Exchange letter dated Dec. 5, 2002; SIG letter dated Dec. 10, 2002; CBOE letter dated Dec. 6, 2002; TD Sec. letter dated Dec. 6, 2002; and STA letter dated Jan. 23, 2003.

³⁸ Joint Exchange letter dated Dec. 5, 2002; SIG letter dated Dec. 10, 2002; CBOE letter dated Dec. 6, 2002; and STA letter dated Jan. 23, 2003.

³⁹ Joint Exchange letter dated Dec. 5, 2002; TD Sec. letter dated Dec. 6, 2002; and STA letter dated Jan. 23, 2003.

⁴⁰ CSE letter dated Dec. 10, 2002.

⁴¹ NASD also is incorporating into the rule text additional exemptions addressed in *Notice to Members 02-63* including: transactions in conventional options; options and futures involving narrow and broad based indexes; and securities futures held in a futures account.

Schedule A to NASD By-Laws

* * * * *

Section 2 – Member Regulatory Fees

(a) No Change.

(b) No Change.

(1) No Change.

(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 that 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[.];

(vi) 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, that are subject to Securities Exchange Act of 1934, Section 11(a) and Rule 11a1-1(T)(a) thereunder; however this exemption does not apply to other transactions permitted by Section 11(a) such as bona fide arbitrage or hedge transactions;

(vii) Transactions by a firm that is a floor based broker and that is a member of both NASD and a national securities exchange provided that the floor based broker qualifies for exemption from NASD membership under Exchange Act Rule 15b9-1;

(viii) Transactions in conventional options;

(ix) Transactions in options and futures involving narrow and broad based indexes; and

(x) Transactions in security futures held in futures accounts.

NASD may exempt other securities and transactions as it deems appropriate.

(3) No change.

(4) No change.

* * * * *

IV. Conclusion

The TAF is an important component of NASD's member regulatory fee structure. The TAF is assessed to recover costs associated with supervising and regulating NASD members. NASD believes that the TAF meets the standards established in Section 15A(b)(5) of the Act because the TAF constitutes a reasonable fee that is equitably allocated. Accordingly, NASD requests that the SEC approve the TAF on a permanent basis.

If you have any questions, please contact Kathleen A. O'Mara, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8056. The fax number of the Office of General Counsel is (202) 728-8264.

Sincerely,

Barbara Z. Sweeney
Senior Vice President and Corporate Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-2002-148)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Proposed Rule Change to By-Laws Regarding the Regulatory Fee and the SEC Section 31 Transaction Fee; Amendment No. 3

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on , the National Association of Securities Dealers, Inc. (“NASD”), filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD is proposing to amend Section 2(b)(2) of Schedule A of the By-Laws of NASD in response to commenters' concerns that certain exemptions discussed in Notices to Members 02-63 and 02-75 could be revoked or modified. NASD is amending the rule filing to incorporate the existing interpretations into the text of the rule. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

* * * * *

¹ 15 U.S.C. § 78s(b)(1).

² 17 CFR § 240.19b-4.

Schedule A to NASD By-Laws

* * * * *

Section 2 – Member Regulatory Fees

(a) No Change.

(b) No Change.

(1) No Change.

(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 that 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[.];

(vi) 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, that are subject to Securities Exchange Act of 1934, Section 11(a) and Rule 11a1-1(T)(a) thereunder; however this exemption does not apply to other transactions permitted by Section 11(a) such as bona fide arbitrage or hedge transactions;

(vii) Transactions by a firm that is a floor based broker and that is a member of both NASD and a national securities exchange provided that the floor based broker qualifies for exemption from NASD membership under Exchange Act Rule 15b9-1;

(viii) Transactions in conventional options;

(ix) Transactions in options and futures involving narrow and broad based indexes; and

(x) Transactions in security futures held in futures accounts.

NASD may exempt other securities and transactions as it deems appropriate.

(3) No change.

(4) No change.

* * * * *

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV

below. NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

NASD is filing with the Commission a rule change to codify an existing interpretation regarding exemptions from its Trading Activity Fee (“TAF”). In Notice to Members 02-75, NASD set forth that the TAF would not be assessed on transactions for non-member broker/dealers who clear through an NASD member broker/dealer unless the NASD member clearing firm acts as the executing broker. In addition, in Notice to Members 02-63 NASD stated that, in general, transactions effected on a national securities exchange by a dually registered specialist or floor based market maker are not be covered by the TAF. Notice to Members 02-63 also clarified that proprietary transactions by a jointly registered NASD member, in its capacity as an exchange specialist or market maker, that are subject to Section 11(a) of the Securities Exchange Act of 1934 and Exchange Act Rule 11a1-1(T)(a) thereunder are generally excluded from the scope of the TAF. Furthermore, Notice to Members 02-63 clarified that transactions in conventional options; options and futures involving narrow and broad based indexes; and securities futures held in a futures account are not covered by the TAF.

NASD reviewed comments received in response to the TAF and determined that certain exemptions discussed in Notices to Members 02-63 and 02-75 should be incorporated into the text of the rule proposal. The exemptions proposed in Amendment No. 3 incorporate existing interpretations and, as such, are conforming technical amendments.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(5) of the Act,³ which requires, among other things, that NASD's rules provide for the equitable allocation of reasonable dues, fees, and other charges among members and issuers and other persons using any facility or system which NASD operates or controls.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were received after SR-NASD-2002-148 (and SR-NASD-2002-98) was published in the Federal Register.⁴ In this amendment, NASD is proposing to expand the exclusions from the TAF in conformity with existing interpretations in response to such comments.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve such proposed rule change, or

³ 15 U.S.C. § 78o-3(b)(5).

⁴ Securities Exchange Act Rel. No. 46817 (Nov. 12, 2002), 67 FR 69784 (Nov. 19, 2002). See also Securities Exchange Act Rel. No. 46416 (Aug. 23, 2002), 67 FR 55901 (Aug. 30, 2002).

- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change [as amended] is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Margaret H. McFarland
Deputy Secretary