NASD™

2003 ANNUAL FINANCIAL REPORT

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This Annual Financial Report does not incorporate by reference any other document or information.

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NASD
MANAGEMENT REPORT ON FINANCIAL OPERATIONS

OVERVIEW

The focus of the National Association of Securities Dealers, Inc. (NASD) on its regulatory mission of investor protection and market integrity has never been more important than it was in 2003, as investors continued to be skeptical in the face of well-publicized abuses in the securities and mutual fund industries. Investor confidence demanded certain, strong, visible action by regulators, and NASD clearly rose to the challenge.

Throughout 2003, NASD was resolute in dealing with problems in the industry, setting a record for the number of enforcement actions, bars and suspensions, and claims filed in its Dispute Resolution division. Rule writing was also an important focus of the organization, especially in the areas of analyst conflicts of interest and Initial Public Offerings (IPOs). NASD vastly expanded information regarding the corporate debt market through the Trade Reporting Compliance Engine (TRACE). NASD also received much praise for its detection of the mutual fund breakpoint issue, and its efforts to help investors receive refunds for missed breakpoint discounts.

The 2003 consolidated financial statements reflect the combined activity of NASD and its subsidiaries, The Nasdaq Stock Market, Inc. (NASDAQ); NASD Regulation, Inc. (NASDR); NASD Dispute Resolution, Inc. (NASD DR); and New NASD Holding, Inc. (NASD Holding), which holds NASD's Class B interest in The American Stock Exchange LLC (Amex). Amex has been reported as a discontinued operation in the consolidated financial statements. (References to NASD and its consolidated subsidiaries throughout are collectively referred to as "the Company")

The Company views its business to consist of two segments as defined by Statement of Financial Accounting Standards (SFAS) No. 131, "Disclosures About Segments of an Enterprise and Related Information." These segments, NASD and NASDAQ, are managed and operated as separate, stand-alone companies with their own corporate governance. NASD consists of the membership and regulatory operations, which are generally considered a self-regulatory organization. NASDAQ consists of the operations of The Nasdaq Stock Market.

While this report reflects the consolidated operations of the Company, the primary focus is on the NASD segment, including NASDR and NASD DR. This focus is consistent with the steps the Company has taken to divest itself of ownership and operation of securities markets and is intended to highlight discussion of areas that will remain with NASD upon completion of the NASDAQ separation and the sale of Amex.

For the year ended December 31, 2003, the Company's consolidated net loss was $57.7 million compared with a net loss of $3.5 million in 2002. Included in the 2003 results are pre-tax charges in NASDAQ continuing operations associated with a strategic review and elimination of non-core product lines of $97.9 million. Also included in the 2003 results are net losses from NASDAQ and Amex discontinued operations of $60.3 million and $47.4 million, respectively. Excluding the effects of losses from discontinued operations from both years, the Company reported income from continuing operations of $50.0 million and $139.6 million in 2003 and 2002, respectively.

2003 highlights for NASD in fulfilling its mission of Investor Protection and Market Integrity:

- After playing an important role in finalizing the $1.4 billion global research analyst settlement against 10 of the nation's largest investment banking firms, NASD also continued to investigate and take enforcement actions against individuals for conflicts of interest between research and investment banking, including a complaint against Phua Young, a former senior analyst at Merrill Lynch, for his research reports on Tyco, Inc. Also, in addition to developing spinning cases against CSFB and SSB in the global settlement, NASD filed an enforcement action against former CSFB investment banker Frank Quattrone alleging IPO spinning and supervisory research violations.

- NASD's Dispute Resolution division had its third consecutive record year, with almost 9,000 new cases filed in its arbitration forum. This represents a 29.3% increase in case filings over two years.

- NASD, through routine examinations in 2002 and 2003, found that in 1 out of 5 transactions in which investors were entitled to a breakpoint discount when purchasing mutual funds, no discount was given. This resulted in hundreds of thousands of mutual fund investors being overcharged by at least $86.0 million in the last two years. NASD directed firms in 2003 to make refunds to customers and has initiated a number of enforcement actions against certain firms that have poor records of providing breakpoint discounts.

- NASD brought several cases in the area of IPO practices. NASD censured and imposed fines of $27.0 million against Robertson Stephens and $6.0 million against J.P. Morgan for sharing in profits from IPOs. NASD also filed a complaint against Invemed, alleging profit sharing activity.

- NASD dramatically increased transparency in the corporate debt market during 2003. It launched Phase II of its overall TRACE dissemination effort in March and April 2003 increasing the number of bonds eligible for dissemination from approximately 535 to 5,000 issues. This increased dissemination of bond trade prices to the public from 41% of the investment grade market in November of 2002 to 69% in November of 2003. Overall average daily volume in the corporate debt market increased to $19.5 billion in 2003 from an average of $17.8 billion in 2002.

- NASD set a record for both the number of new enforcement actions filed (1,352) and the number of individuals barred or suspended (830) from the securities industry as a result of violations of securities rules and laws.

- NASD brought more than 60 enforcement actions against securities firms in 2003 for violations in the area of mutual fund sales. Violations in these cases included suitability of the mutual fund share classes that brokers recommended, sales practices, improper disclosures and compensation arrangements between the funds and brokers. The 60 mutual fund-related actions bring to more than 200 the number of cases NASD has taken in the investment company area since 2000.

- NASD approved the establishment of the NASD Investor Education Foundation (the Foundation), whose mission will be to provide investors with high-quality, easily accessible information and tools to better understand investing and the markets. In March 2004, the Foundation was funded with an initial endowment of $10.0 million to be used to fund educational programs, materials and research aimed at segments of the investing public that could benefit from additional resources.

RESULTS OF OPERATIONS

REVENUES

The following table sets forth consolidated revenues by segment and revenue category:

NASD CONSOLIDATED REVENUES BY SEGMENT (in Millions)

	Years ended December 31, 2003				2002			
	NASD	NASDAQ	Consolidating Adjustments	Consolidated	NASD	NASDAQ	Consolidating Adjustments	Consolidated
Transaction services	$ –	$236.0	$ (1.6)	$ 234.4	$ –	$380.6	$ (0.1)	$ 380.5
Market information	13.3	147.1	–	160.4	5.6	199.6	–	205.2
Issuer services	–	167.3	–	167.3	–	173.3	–	173.3
Member regulatory fees	175.4	–	–	175.4	177.5	–	–	177.5
Contract services fees	61.9	–	(61.9)	–	76.7	–	(76.7)	–
Registration fees	65.8	–	–	65.8	69.6	–	–	69.6
Dispute resolution fees	75.5	–	(0.1)	75.4	59.6	–	–	59.6
Qualification fees	40.4	–	–	40.4	37.7	–	–	37.7
Corporate financing fees	10.1	–	–	10.1	10.5	–	–	10.5
Other	29.6	39.4	(4.0)	65.0	13.2	33.7	(3.7)	43.2
Operating revenues	472.0	589.8	(67.6)	994.2	450.4	787.2	(80.5)	1,157.1
Fines	33.3	–	–	33.3	68.2	–	–	68.2
Total revenues	$505.3	$589.8	$(67.6)	$1,027.5	$518.6	$787.2	$(80.5)	$1,225.3

NASD

NASD total revenues were $505.3 million in 2003 compared with $518.6 million in 2002, a decrease of $13.3 million or 2.6%.

Market information represents fees charged on secondary market transactions in eligible fixed income securities reported to NASD through TRACE, TRACE system related fees, and TRACE market data fees. Market information revenues were $13.3 million in 2003 compared with $5.6 million in 2002, a 137.5% increase. This increase was due to the full-year operation of the TRACE program in 2003, which was approved by the Securities and Exchange Commission (SEC) and became operational in July 2002.

Member regulatory fees include the transaction-based Trading Activity Fee, as well as assessments based on the gross income and number of personnel of member firms. These fees are used to fund NASD's member regulatory activities, including the regulation of members through examinations, processing of membership applications, financial monitoring, policymaking, rulemaking, and enforcement activities. In 2002, NASD amended its member regulatory fee pricing structure to better align NASD's regulatory fees with its functions, efforts, and costs. Member regulatory fees were $175.4 million in 2003 compared with $177.5 million in 2002, a decrease of $2.1 million or 1.2%.

Contract services fees represent amounts charged to NASDAQ associated with surveillance monitoring, legal and enforcement activities. Contract services fees totaled $61.9 million in 2003 compared with $76.7 million in 2002, a decrease of $14.8 million or 19.3%. The decrease was primarily due to controlled spending and the allocation of charges among markets that NASD regulates. These amounts represent intercompany charges to the Company that are eliminated in consolidation.

Registration fees, **net** were $65.8 million in 2003 compared with $69.6 million in 2002, a decrease of $3.8 million or 5.5%. Registration fees are reported net of the accrual for surplus amounts generated under the Investment Adviser Registration

Depository (IARD) program. As defined in the memorandum of understanding with the SEC and similar arrangements, the net surplus of the program is payable for enhancements to the IARD program and for the benefit of IARD registrants upon termination of the contract. The IARD program generated a net surplus for the first time in 2003.

Dispute resolution fees experienced another record year totaling $75.5 million in 2003 compared with $59.6 million in 2002, an increase of $15.9 million or 26.7%. In 2003, almost 9,000 new cases were filed in NASD's arbitration forum, representing an increase of 1,241 cases or a 16.1% increase from the number of cases filed in 2002. An additional 202 cases were filed directly in mediation, which is down from 275 in the previous year.

Qualification fees remained relatively constant based on static registered representative populations and testing volumes. Qualification fees totaled $40.4 million in 2003 compared with $37.7 million in 2002, an increase of $2.7 million or 7.2%.

Corporate financing fees also remained consistent year-over-year due to continued low levels of IPO and corporate debt offerings. Corporate financing fees were $10.1 million in 2003 compared with $10.5 million in 2002, a decrease of $0.4 million or 3.8%. Corporate filings for 2003 totaled 753 as compared with 765 in 2002.

Other revenues increased to $29.6 million in 2003 compared with $13.2 million in 2002, due mainly to the revenues associated with the launch of the Alternative Display Facility (ADF) in late 2002. For 2003, ADF revenues totaled $7.8 million related to market data revenue from the Unlisted Trading Privileges plan based on their respective share volume and trades of securities listed on The Nasdaq Stock Market. These revenues were derived primarily through trade reporting and transaction volume from one large ECN. In February 2004, this ECN began directing the majority of its transactions through another exchange.

Fines represent sanctions collected for rules violations, which NASD does not view to be part of operating revenues. Fines totaled $33.3 million in 2003 compared with $68.2 million in 2002, a decrease of $34.9 million or 51.2%. The decline in fines year-over-year was due to the receipt of a $50.0 million fine in January 2002, related to CSFB and their taking of inflated commissions in what amounted to profit sharing arrangements on IPOs. Included in 2003 were large receipts of $14.0 million from Robertson Stephens and $6.0 million from J.P. Morgan, also for penalties on profit sharing arrangements on IPOs.

NASDAQ

NASDAQ total revenues declined $197.4 million from $787.2 million in 2002 to $589.8 million in 2003, due mainly to declines in transaction service and market information revenues. Declines in transaction service revenues were tied to a decline in the number of trader log-ons to NASDAQ systems, as well as lower market share and the elimination of the quote update fee. Declines in market information revenues related to a decrease in service subscriptions and the overall loss in market share.

Consolidating Adjustments

Consolidating adjustments represent the elimination of intercompany charges at the Company level, primarily contract services fees charged by NASD to NASDAQ.

TOTAL EXPENSES

The following table summarizes total operating expenses by segment and category:

NASD CONSOLIDATED OPERATING EXPENSES BY SEGMENT (in Millions)

	Years ended December 31, 2003				2002			
	NASD	NASDAQ	Consolidating Adjustments	Consolidated	NASD	NASDAQ	Consolidating Adjustments	Consolidated
Compensation and benefits	$267.8	$159.1	$ 0.2	$ 427.1	$234.0	$183.1	$ –	$ 417.1
Professional and contract services	119.6	37.5	(0.8)	156.3	134.1	60.5	0.4	195.0
Computer operations and data communications	19.1	125.6	–	144.7	19.7	136.6	–	156.3
Depreciation and amortization	44.4	90.0	–	134.4	54.7	88.5	–	143.2
Occupancy	30.1	31.2	–	61.3	24.0	32.4	0.5	56.9
Other	37.1	110.9	(57.8)	90.2	36.3	159.0	(75.3)	120.0
Elimination of non-core products	–	97.9	–	97.9	–	–	–	–
NASDAQ Japan impairment loss	–	(5.0)	–	(5.0)	–	15.2	–	15.2
Total expenses	$518.1	$647.2	$(58.4)	$1,106.9	$502.8	$675.3	$(74.4)	$1,103.7

NASD

NASD total operating expenses were $518.1 million in 2003 compared with $502.8 million in 2002, an increase of $15.3 million in 2003 or 3.0%.

Compensation and benefits increased $33.8 million or 14.4% due to an increase the number of technology and arbitration personnel, as well as general increases in medical costs and benefits expenses. Total head count was 2,085 as of December 31, 2003, compared to 2,011 as of December 31, 2002. Increases in medical expenses were tied to the overall increase in cost of health care, as well as a higher claims experience for existing employees. Increases associated with the company’s defined benefit plan were due to reductions in the discount rate and lower returns in the equity markets in recent years.

Professional and contract services were $119.6 million in 2003 compared to $134.1 million in 2002, a decline of $14.5 million or 10.8%. Professional and contract services represent primarily technology consulting services incurred with Electronic Data Systems Corporation (EDS) and other technology vendors. Overall declines year-over-year relate primarily to the internalization of technology resources, renegotiated rates under the new EDS contract, and several large one-time initiatives, which were completed in 2002. In 2002, NASD developed and implemented the ADF, upgraded its financial systems, and incurred costs associated with the NASDAQ share buyback. Also contributing to the decline in contract services were cost containment measures combined with controlled initiative spending.

Computer operations and data communications remained relatively consistent between years at $19.1 million in 2003 compared with $19.7 million in 2002, a decrease of $0.6 million or 3%.

Depreciation and amortization expense declined $10.3 million or 18.8% due to the migration to newer and less costly data center equipment in 2002.

Occupancy expense was $30.1 million in 2003 compared with $24.0 million in 2002, an increase of $6.1 million or 25.4%, due mainly to contract termination costs accrued in 2003 associated with vacated space at one of NASD's leased locations in Rockville, Maryland.

Other expenses were consistent between years at $37.2 million in 2003 compared with $36.3 million in 2002, a decrease of $0.9 million or 2.5%. Included in other expenses are the company's general business expenditures on matters such as travel, supplies, and marketing.

NASDAQ

Overall, NASDAQ total expenses were $647.2 million in 2003 compared with $675.3 million in 2002, a decrease of $28.1 million or 4.2%. Included in NASDAQ's 2003 total expenses are costs associated with the elimination of non-core product lines of $97.9 million. Excluding the elimination in non-core product lines and NASDAQ Japan impairment losses from both years, the decrease in NASDAQ total expense would have been $105.8 million or 16%. This significant decrease in total expenses was attributable to reductions in almost all expense categories, with the most significant declines tied to large cuts in head count, contract services, and reductions in other expenses from lower equity investment losses. Also included in NASDAQ total expenses are charges associated with regulatory services performed by NASD, which are eliminated at the Company level in consolidation.

Consolidating Adjustments

Consolidating adjustments represent the elimination of intercompany charges at the Company level, primarily contract services fees charged by NASD to NASDAQ.

OTHER INCOME (EXPENSE)

The following table summarizes total other income (expense) by segment and category:

NASD CONSOLIDATED OTHER INCOME (EXPENSE) BY SEGMENT (in Millions)

	Years ended December 31, 2003				2002			
	NASD	NASDAQ	Consolidating Adjustments	Consolidated	NASD	NASDAQ	Consolidating Adjustments	Consolidated
Interest and dividend income	$42.0	$ 9.5	$ (8.1)	$ 43.4	$ 37.8	$ 12.6	$ 0.8	$ 51.2
Interest expense	(0.1)	(18.6)	–	(18.7)	(0.2)	(18.5)	–	(18.7)
Net realized investment gains	24.6	–	(0.3)	24.3	(48.2)	–	(0.8)	(49.0)
Gain on NASDAQ warrants	16.1	–	–	16.1	104.7	–	–	104.7
Net losses from equity investees	–	–	(4.1)	(4.1)	–	–	(12.1)	(12.1)
Minority interest benefit (expense)	–	–	47.2	47.2	–	–	(17.2)	(17.2)
Total other income (expense)	$82.6	$ (9.1)	$34.7	$108.2	$ 94.1	$ (5.9)	$(29.3)	$ 58.9

NASD

NASD total other income was $82.6 million in 2003 compared with $94.1 million in 2002, a decrease of $11.5 million or 12.2%. In 2003, NASD posted net realized gains from its investment portfolio of $24.6 million in comparison to net losses of $48.2 million in 2002. This large swing is reflective of the overall positive performance in the equity markets in 2003. Offsetting the increase to other income from NASD's investment portfolio was a reduction between years in the gain recognized on the change in value of warrants to purchase NASDAQ stock from NASD. With the lifting of transfer restrictions on NASDAQ common stock in 2002 and the trading of NASDAQ common stock on an over-the-counter market, NASD began marking the outstanding warrants to market as a derivative instrument. In 2002, NASD recognized a $104.7 million gain and in 2003 NASD recorded an additional gain of $16.1 million. As of December 31, 2003, $120.8 million of the original $128.5 million in proceeds received from the sale of warrants had been realized due to the change in market value.

NASDAQ

NASDAQ recognized net other expense in both 2003 and 2002, with interest expense on outstanding debt exceeding interest income generated by its cash and investment portfolio.

Consolidating Adjustments

Consolidating adjustments represent mainly the intercompany elimination of dividends on NASDAQ preferred stock recognized by NASD, as well as NASD's sharing of losses in NASDAQ with minority interest partners. Minority interest benefit (expense) increased from expense of $17.2 million in 2002 to a benefit of $47.2 million in 2003, reflective of the minority interest partners' share of NASDAQ's net income and net loss in those periods.

PROVISION FOR INCOME TAXES

As NASD is a tax-exempt organization under the provisions of the Internal Revenue Code Section 501(c)(6), tax expenses represent the tax expense of NASDAQ. The Company recorded a tax benefit in 2003, with an effective tax rate of 32.0%, and a tax provision in 2002, with an effective tax rate of 38.6%. The change from a tax provision in 2002 to a tax benefit in 2003 is related to the net loss reported by Nasdaq in 2003. The change in the effective tax rate in 2003 was driven by a goodwill write-off, which was not deductible for U.S. income tax purposes, thus reducing the tax benefit realized in 2003.

DISCONTINUED OPERATIONS

Discontinued operations in the Company's consolidated statements reflect charges taken by both NASD Holding and NASDAQ. See the table below for a breakdown by company by year.

	Years ended December 31,	
	2003	**2002**
	(in millions)	
Loss From Discontinued Operations:		
NASD Holding	$ 47.4	$121.2
NASDAQ	60.3	21.9
Total	$107.7	$143.1

NASD

NASD Holding's net loss from discontinued operations represents the operations of Amex for the period, net of intercompany eliminations and taxes, as well as the estimated loss at disposal recorded as of December 31, 2003, and 2002. NASD accounted for Amex as a discontinued operation in the 2002 consolidated statements based on the planned sale to a Chicago-based private equity firm. In 2003, this firm informed NASD that it no longer wished to pursue negotiations related to the sale of NASD's interest in Amex. On October 31, 2003, NASD agreed in principle to sell its ownership interest in Amex to Amex Membership Corporation. In 2003, the overall conditions of the sale to Amex Membership Corporation were evaluated and the loss from discontinued operations was revised to reflect the terms of the new agreement with Amex Membership Corporation. On March 18, 2004, the members of Amex Membership Corporation voted at a special meeting to approve the transaction. The primary remaining step in the transaction is approval from the SEC. Management believes that the sale of its investment in Amex will be completed within one year and that it is unlikely that significant changes will be made to the plan to sell. See Note 15, "Discontinued Operations," to the consolidated financial statements for further discussion.

NASDAQ

NASDAQ's net loss from discontinued operations represents losses associated with NASDAQ Europe and IndigoMarkets Ltd. As a result of its strategic review, NASDAQ supported the closing of the market operated by NASDAQ Europe. These operations were wound down pursuant to a transition plan approved by the Belgian Banking and Finance Commission. As NASDAQ Europe was winding down its market operations, NASDAQ reached an agreement to transfer all of NASDAQ's shares in NASDAQ Europe to one of the original investors in NASDAQ Europe. The transfer of shares was completed in December 2003. NASDAQ made a similar decision to discontinue operations in IndigoMarkets Ltd. and recorded a nominal gain on the disposition of those operations through the sale of its interest in the joint venture. See Note 15, "Discontinued Operations," to the consolidated financial statements for further discussion.

LIQUIDITY AND CAPITAL RESOURCES

Consistent with the Company's operation of its business segments as separate stand-alone companies with their own corporate governance, NASD and NASDAQ separately manage their liquidity and capital resources. Each segment's Board has approved its respective investment policies for internally and externally managed portfolios.

NASD

NASD's investment policy has been developed based on best practices as applied to its investment objectives. The NASD Investment Committee, whose members have extensive background and experience in the investment community, provides overall guidance and advice in determining the appropriate policy, guidelines and allocation for these investments. NASD engages an investment consultant to support the Investment Committee in the areas of policy and guidelines and to monitor the performance of the portfolio and investment managers, including periodic selection and evaluation of asset managers.

The goal of NASD's investment policy is to preserve principal, both in absolute and real terms (adjusted for inflation), while seeking to maximize returns within acceptable levels of risk in a manner consistent with the best practices for producing long-term returns. Portfolio returns may be used for funding current operating budget needs, maintaining real purchasing power for future contingencies, or for other strategic or operational purposes. As part of this policy, NASD targeted 0 to 30% of its portfolio to equities, 50 to 80% to fixed income, and 10 to 25% of its portfolio to cash and cash equivalents. As of December 31, 2003, NASD held approximately 21% of its portfolio in equities, including mutual funds, and 73% in fixed income, cash and cash equivalents, and other securities. In January 2004, the NASD Board approved changes to its policy, which included revising the targeted allocations to 50 to 65% equities, 20 to 30% fixed income, and 15-20% to alternative investments in connection with adopting best practices for endowment type portfolios.

NASDAQ

The goal of NASDAQ's investment policy is to maintain adequate liquidity at all times, to fund current budgeted operating and capital requirements and to maximize returns. All securities must meet credit rating standards as established by the policy. The investment duration must not exceed 18 months. As of October 2003, the policy prohibits the purchasing of equity securities.

Cash Flows

Both NASD and NASDAQ rely on cash flows from operations to provide working capital for current and future operations. The Company's net cash provided by operating activities was $183.5 million and $322.3 million for 2003 and 2002, respectively. Net cash used in investing and financing activities by the company in 2003 and 2002 was $182.7 million and $351.3 million, respectively.

See table below for total cash flows by segment between years:

	Years ended December 31 (in millions)					
	2003			2002		
	NASD	NASDAQ	Total	NASD	NASDAQ	Total
Operating:						
Continuing	$101.0	$ 145.8	$ 246.8	$ 227.0	$ 183.2	$ 410.2
Discontinued operations	(22.8)	(40.5)	(63.3)	(59.3)	(28.6)	(87.9)
Total operating	78.2	105.3	183.5	167.7	154.6	322.3
Investing	(77.0)	(0.2)	(77.2)	(391.5)	(86.5)	(478.0)
Financing	52.1	(157.6)	(105.5)	274.5	(147.8)	126.7
Total	$ 53.3	$ (52.5)	$ 0.8	$ 50.7	$ (79.7)	$ (29.0)

NASD

During 2003, NASD generated cash flow from continuing operations of $101.0 million. NASD incurred investing cash flows outflows of $77.0 million in 2003, primarily due to the purchase of liquid securities in an effort to maximize returns on funds that were previously included in cash and cash equivalents at December 31, 2002. Also included in investing cash outflows were normal capital expenditures for the period. NASD capital expenditures of $19.1 million in 2003 related primarily to capitalized software development costs and minor building and technology improvements. In 2002, capital expenditures were $29.6 million and were primarily related to the development of the ADF system and the purchase of more efficient data-center hardware. Financing cash in-flows to NASD represent mainly higher collections of Net SEC fees associated with the rate change effective in April of 2003.

NASD has been able to generate sufficient funds from operations to meet working capital requirements. NASD has a $50.0 million line of credit available through November of 2004, should it temporarily need liquidity to meet its current obligations. The Company believes that the liquidity provided by existing cash and cash equivalents, investments, and cash generated from operations will provide sufficient capital to meet current and future operating requirements.

NASD working capital was $961.6 million at December 31, 2003, compared with $799.5 million at December 31, 2002.

NASDAQ

Cash flows from operating activities totaled $145.8 million in 2003 and $183.2 million in 2002. The decrease in operating cash flows was primarily due to payments for the elimination of non-core product lines, initiatives, and severance. Net cash used in investing and financing activities was $157.8 million in 2003 and $234.3 million in 2002. Capital expenditures for 2003 were $31.6 million compared with $75.2 million in 2002. The decline in capital spending was primarily attributable to the deployment of Nasdaq Market Center in 2002. In 2003, NASDAQ redeemed $150.0 million in Senior Notes, which are included in financing activities.

CONTRACTUAL OBLIGATIONS AND CONTINGENT COMMITMENTS

The Company has contractual obligations to make future payments under several contracts. A combined summary of those contractual obligations is provided below.

	Total	Less than 1 year	1 – 3 years	3 – 5 years	More than 5 years
			(in millions)		
Long-term debt by contract maturity (NASDAQ)	$ 265.0	$ –	$ 240.0	$ 4.0	$ 21.0
Minimum rental commitments under non-cancelable operating leases	439.3	37.0	69.0	61.8	271.5
Minimum rental commitments under capitalized leases	4.0	2.3	1.6	0.1	–
Other long-term obligations	205.7	51.7	43.0	41.0	70.0
Total	$914.0	$91.0	$353.6	$106.9	$362.5

Long-term debt represents NASDAQ's $25.0 million Senior Note payable and NASDAQ's $240.0 million convertible subordinated notes. Principal payments on the $25.0 million note are scheduled to begin in 2007 and continue in equal monthly installments until maturity in 2012. The $240 million convertible subordinated notes become due in May of 2006. See Note 8, "Borrowings," to the consolidated financial statements for further discussion.

Minimum rental commitments under non-cancelable operating leases represent totals of NASD and NASDAQ. The majority of these leases contain escalation clauses based on increases in property taxes and building operating costs. Of the amounts presented, NASD operating lease commitments totaled $142.4 million and NASDAQ commitments were $296.9 million. Commitments under capitalized leases are solely attributable to NASDAQ.

Other long-term obligations reflect the combination of NASD's information and technology services agreement with EDS and NASDAQ's global services agreement with MCI.

NASDAQ RESTRUCTURING

NASD and NASDAQ are currently awaiting the SEC's decision on Exchange Registration for NASDAQ. Upon Exchange Registration, NASD will no longer exert voting control over NASDAQ and, as such, NASD expects that it will cease to consolidate NASDAQ. The following discussion details steps taken to date in the disposition of NASDAQ and the impact on the consolidated operations of the Company.

Previous NASD transactions in NASDAQ stock include Phase I and Phase II sales of NASDAQ common shares and warrants in 2001 and 2000. On May 3, 2001, NASD further decreased its ownership through a two-part transaction, which resulted in the issuance of convertible debt by NASDAQ to the private equity firm of Hellman & Friedman, and the subsequent repurchase of shares by NASDAQ from NASD.

In March 2002 NASD sold 33.8 million shares of NASDAQ common stock to NASDAQ, reducing its ownership of NASDAQ to 55% prior to the exercise of warrants. Assuming the full exercise of all warrants purchased in Phase I and II of the NASDAQ restructuring, this transaction effectively reduced NASD's ownership of NASDAQ common shares to zero on a fully diluted basis. In exchange for the shares sold, NASDAQ paid NASD $305.2 million in cash, issued 1,338,402 shares of Series A Preferred Stock, and one share of Series B Preferred Stock. Due to the expiration of the first tranche of warrants in June of 2003, NASD's ownership in NASDAQ on a fully diluted basis has increased to 13.7% as of December 31, 2003.

With its 55% ownership and one share of Series B Preferred Stock, NASD continues to exert voting control over NASDAQ and therefore continues to consolidate NASDAQ's operations under accounting principles generally accepted in the United States.

NASDAQ applied for registration as an exchange with the SEC in March 2001. If Exchange Registration is approved, warrant holders will have the right to direct the voting of the shares of NASDAQ common stock underlying the unexercised and unexpired warrants. At that time, NASD will no longer exert voting control and will cease to consolidate NASDAQ's operations in the Company's consolidated financial statements.

The table below summarizes the effect of all NASD and NASDAQ transactions in NASDAQ stock during the period June 2000 to December 2003.

EFFECT OF NASDAQ RESTRUCTURING ACTIVITIES (dollars in millions)

	NASD Ownership %	Fully Diluted %	NASDAQ Shares Owned by NASD	Increase in Consolidated Equity	(Increase) Decrease in Minority Interests	Increase in Liabilities	Consolidated Cash Proceeds
Year Ended 12/31/99	**100.0%**	**100.0%**	**49,999**	**–**	**–**	**–**	**–**
Stock Split	100.0%	100.0%	100,000,000	–	–	–	–
Phase I—Shares	(19.4)%	(19.4)%	(323,796)	$(138.6)	$(118.2)	$ –	$256.8
Phase I—Warrants	–	(20.7)%	–	–	–	(68.7)	68.7
Ending Balance/Cumulative Impact-Year Ended 12/31/00	**80.6%**	**59.9%**	**99,676,204**	**(138.6)**	**(118.2)**	**(68.7)**	**325.5**
Phase II—Shares	(6.4)%	(6.4)%	(4,219,795)	(59.2)	(58.0)	–	117.2
Phase II—Warrants	–	(12.9)%	–	–	–	(59.9)	59.9
Hellman & Friedman	(4.3)%	(13.0)%	(18,461,538)	(40.5)	40.5	(240.0)	240.0
Other NASDAQ	(0.9)%	(2.3)%	–	(9.2)	(4.9)	–	14.1
Ending Balance/Cumulative Impact-Year Ended 12/31/01	**69.0%**	**25.3%**	**76,994,871**	**(247.5)**	**(140.6)**	**(368.6)**	**756.7**
NASDAQ Share Buyback—March 2002 ***	(13.5)%	(25.3)%	(33,768,895)	(122.9)	122.9	–	–
Other NASDAQ & Warrant Exercises	(0.3)%	–	(20,830)	(1.0)	(1.2)	–	2.2
Ending Balance/Cumulative Impact-Year Ended 12/31/02	**55.2%**	**–**	**43,205,146**	**(371.4)**	**(18.9)**	**(368.6)**	**758.9**
Warrant Exercises	–	13.7%	(15,000)	–	–	–	0.2
Other NASDAQ	(0.2)%	–	–	(0.8)	(0.7)	–	1.5
Ending Balance/Cumulative Impact-Year Ended 12/31/03	**55.0%**	**13.7%**	**43,190,146**	**$(372.2)**	**$ (19.6)**	**$(368.6)**	**$760.6**
Cash Proceeds—NASD *							$731.0
Cash Proceeds—NASDAQ **							29.6
Total Cash Proceeds							**$760.6**

* Reflects the effect of two NASDAQ buybacks of its shares from NASD amounting to $240.0 million (the Hellman & Friedman transaction in 2001) and $305.2 million (the March 2002 transaction).

** Reflects the $240 million as a pass through and the $305.2 million as a payment to NASD out of proceeds received during Phase I and II.

*** In connection with the March 2002 share buyback NASD also received 1,338,402 shares of Series A Preferred Stock and one share of Series B Preferred Stock.

Warrants to purchase NASDAQ common shares are exercisable in four annual tranches. The first annual tranche became exercisable on June 28, 2002. As of December 31, 2003, 35,830 shares had been purchased through the exercise of warrants. The exercise period for the first tranche of warrants expired on June 27, 2003.

A summary of the key dates and sequence of events described in the preceding paragraphs is provided below.

EVENT	DATE
Phase I	June 28, 2000
Phase II	January 18, 2001
NASDAQ Submits Exchange Registration Application	March 15, 2001
2001 NASDAQ Share Buyback (Hellman & Friedman)	May 3, 2001
2002 NASDAQ Share Buyback	March 8, 2002
Transfer Restrictions Expired	June 28, 2002
Warrant Exercise Period—1st Tranche—(Expired)	June 27, 2003
Warrant Exercise Period—2nd Tranche	June 30, 2003–June 25, 2004
Warrant Exercise Period—3rd Tranche	June 28, 2004–June 27, 2005
Warrant Exercise Period—4th Tranche	June 28, 2005–June 27, 2006
Exchange Registration Approval	Unknown

QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Market risk represents the risks of changes in value of a financial instrument, derivative or non-derivative, caused by fluctuations in interest rates, foreign exchange rates, and equity prices. As of December 31, 2003, investments in the Company's consolidated financial statements consisted of equities, U.S. Treasury securities, obligations of U.S. Government-sponsored enterprises, and other financial instruments.

The Company's primary market risk is with respect to its investment portfolio and is associated with fluctuations in the equities markets, as well as fluctuations in interest rates and the effects that both types of fluctuations may have on its investment portfolio and outstanding debt. NASDAQ's investment portfolio is held primarily in investments with maturities averaging less than one year and NASDAQ's debt obligations generally specify a fixed interest rate. Therefore, NASDAQ does not believe that a 100 basis-point fluctuation in market interest rates will have a material effect on the carrying value of the investment portfolio or earnings or cash flow.

NASD's investment portfolio also contains fixed income securities. However, NASD's fixed income securities have a longer maturity than NASDAQ's, with a duration, or weighted average maturity of cash flows, of approximately 3.3 years as of December 31, 2003. Duration is a measure of the sensitivity of a fixed income portfolio to a change in interest rates: for every 100 basis point change in interest rates, a portfolio with a duration of 3.3 years is expected to change inversely by 3.3%. NASD believes that any decline in the value of its fixed income securities due to a 100 basis point increase in interest rates should be largely offset by the portfolio's yield of approximately 3.4%.

NASD maintains a portion of its portfolio in equity securities, which have been more sensitive to market fluctuations. NASD reviews its investment portfolio for other-than-temporary declines on a quarterly basis. Based on these reviews in 2002, NASD recorded impairment charges for other-than-temporary declines of $33.7 million. In 2003, due to overall positive performance in the equity markets, NASD recorded impairment charges of only $0.1 million. NASD management believes that other-than-temporary fluctuations in market indices could have a significant impact on NASD's investment portfolio and earnings and cash flows.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of the Company's financial statements in conformity with generally accepted accounting principles requires management to adopt accounting principles and make estimates and judgments to develop amounts reported in the financial statements and accompanying notes.

The Company periodically reviews the application of its accounting policies and evaluates the appropriateness of the estimates that are required to prepare the financial statements. The Company believes our estimates and judgments are reasonable; however, actual results and the timing of recognition of such amounts could differ from those estimates.

The Company's significant accounting policies are described in Note 2, "Summary of Significant Accounting Policies," to the consolidated financial statements. The following provides information about the Company's critical accounting policies, which are defined as those that are reflective of significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. At the consolidated level, the Company has determined that the critical accounting policies are those that cover investments, revenue recognition, software costs, impairment of long-lived assets, and pension benefits.

INVESTMENTS

Under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," management determines the appropriate classification of investments at the time of purchase. Investments for which the Company does not have the intent or ability to hold to maturity are classified as "available-for-sale" and are carried at fair value, with the unrealized gains and losses, net of tax, reported as a separate component of members' equity. Investments for which the Company has the intent and ability to hold to maturity are classified as "held-to-maturity" and are carried at amortized cost. The amortized cost of debt securities classified as held-to-maturity is adjusted for amortization of premiums and accretion of discounts. Realized gains and losses on sales of securities are included in earnings using the average cost method. Amounts due to or from the custodial agent relate to securities trades executed prior to the balance sheet date but not yet settled.

The Company periodically reviews its investments to determine whether a decline in fair value below the cost basis is other-than-temporary. If the decline in the fair value is judged to be other-than-temporary, the cost basis of the investment is written down to fair value, the amount of the write-down is charged to earnings, and a new cost basis for the security is established.

REVENUE RECOGNITION

Market information revenues for NASD are based on secondary market transactions in eligible fixed income securities reported to NASD. Market information revenues for NASDAQ are based on the number of presentation devices in service and quotes delivered through those devices and are recognized in the month that information is provided. These revenues are recorded net of amounts due under revenue sharing arrangements with market participants. Market information services are recognized in the month that information is provided. Transaction service fees, regulatory service fees, registration fees, and qualification fees are variable based on service volumes and are recognized as transactions occur. Member regulatory fees on NASD-regulated firms are recognized evenly over the year to which the fee relates and are recorded net of any rebates paid to firms. Initial registration fees for members are recognized once the registration process is completed. Issuer services consist primarily of annual listing fees, initial listing fees (IL), and listing of additional shares fees (LAS) fees. Annual listing service revenues are recognized ratably over the following twelve-month period. IL and LAS fees are recognized on a straight-line basis over their estimated service periods. Arbitration fees are recognized as revenue when cash is received. When a case is closed and the final billings are prepared, any unpaid fees are recognized as revenue. Fines are recognized when the cash is received.

SOFTWARE COSTS

Significant purchased application software, and operational software that is an integral part of computer hardware, are capitalized and amortized on the straight-line method over their estimated useful lives, generally two to seven years. All other purchased software is charged to expense as incurred. In accordance with Statement of Position (SOP) No. 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," the Company capitalizes internal computer software development costs incurred during the application development stage. Computer software costs incurred prior to or subsequent to the application development stage are charged to expense as incurred.

IMPAIRMENT OF LONG-LIVED ASSETS

The Company reviews its long-lived assets for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long Lived Assets." In the event that facts and circumstances indicate that long-lived assets or other assets may be impaired, an evaluation of recoverability would be performed. If an evaluation were required, the estimated future undiscounted cash flows associated with the asset would be compared to the asset's carrying amount to determine if a write-down is required. If impairment were indicated, the Company would prepare a discounted cash flow analysis to determine the amount of the impairment.

PENSION BENEFITS

The Company provides two non-contributory defined benefit pension plans for the benefit of eligible employees of its subsidiaries. The non-contributory defined benefit plan consists of a funded Employee Retirement Plan (ERP) and an unfunded Supplemental Executive Retirement Plan (SERP). Several statistical and other factors, which attempt to anticipate future events, are used in calculating the expense and liability related to the plans. Key factors include assumptions about the expected rates of return on plan assets and discount rates as determined by the Company, within certain guidelines. The Company considers market conditions, including changes in investment returns and interest rates, in making these assumptions. The Company determines the long-term rate of return based on analysis of historical and projected returns as prepared by the Company's actuary and external investment consultant. The discount rate used in the calculations is tracked to changes in Moody's Aa bond ratings. The Company's Pension Plan Committee approves both the expected long-term rate of return and the discount rate assumptions.

Unrecognized actuarial gains and losses are being recognized over time in accordance with SFAS No. 87, "Employers Accounting for Pensions." Unrecognized actuarial gains and losses arise from several factors including experience and assumption changes in the obligations, and from the difference between expected returns and actual returns on plan assets.

The actuarial assumptions used by the Company in determining its pension benefits may differ materially from actual results due to changing market conditions and economic conditions, as well as early withdrawals by terminating plan participants. While the Company believes that the assumptions used are appropriate, differences in actual experience or changes in assumptions may materially affect the Company's financial position or results of operations.

RECENT ACCOUNTING PRONOUNCEMENTS

See Note 2, "Summary of Significant Accounting Policies," for discussion of recent accounting pronouncements. The Company does not believe the adoption of recent accounting pronouncements will have a material impact on the Company's earnings and financial position.

CERTIFICATION FOR 2003 ANNUAL FINANCIAL REPORT

We, Robert R. Glauber and Todd T. Diganci, certify that:

1. We have reviewed this annual financial report of the National Association of Securities Dealers, Inc. (NASD);
2. The purpose of this report is principally to set forth management's report on financial operations with respect to NASD during the year ended December 31, 2003, together with the consolidated financial statements of NASD as of and for the year ended December 31, 2003 and 2002, and this report is not intended to comply with the substantive or form requirements for periodic reports under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and the rules and regulations promulgated thereunder (the "Exchange Act Rules and Regulations") required of issuers of securities subject to the periodic reporting requirements under Sections 12, 13 and 15 of the Exchange Act of 1934 and the related Exchange Act Rules and Regulations;
3. Based on our knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
4. Based on our knowledge, the financial statements and other financial information set forth under the caption "Management Report on Financial Operations", fairly present in all material respects the financial condition, results of operations and cash flows of NASD as of, and for, the periods presented in this report;
5. NASD has established disclosure controls and procedures to ensure that material information relating to NASD, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
6. NASD has carried out its evaluation of the effectiveness of the design and operation of NASD's disclosure controls and procedures as of December 31, 2003. Based upon that evaluation, we have concluded that the disclosure controls and procedures are effective;
7. We have disclosed, based on NASD's most recent evaluation of internal control over financial reporting, to NASD's auditors and the Audit Committee of NASD's Board of Governors:
    a) Any significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect NASD's ability to record, process, summarize and report financial information; and
    b) Any fraud, whether or not material, that involves management or other employees who have a significant role in NASD's internal control over financial reporting.

Date: June 28, 2004

Robert R. Glauber

Robert R. Glauber
Chairman and CEO

Todd T. Diganci
Executive Vice President and CFO

AUDIT COMMITTEE REPORT

In accordance with its written Charter adopted by the Board of Governors, the Audit Committee of the Board of Governors assists the Board in fulfilling its responsibility for oversight of the quality and integrity of the accounting, auditing, and financial reporting practices of NASD. Each member of the Committee is an independent director as defined by SEC Rule 10A-3 under the 34 Act, Listing Standards Relating to Audit Committees. In addition, the Audit Committee has determined that James E. Burton and Charles A. Bowsher are audit committee financial experts, as defined by the SEC. The Charter gives the Audit Committee responsibility for monitoring the independence of the independent auditors and recommending the appointment of the independent auditors for approval by the Board of Governors, and makes clear that the independent auditors are accountable to the Audit Committee and the Board of Governors, as representatives of the members and the public. In all respects, the Charter complies with standards applicable to publicly owned companies. In addition, the Charter and the By-laws of NASD make the Director of Internal Audit directly responsible to the Audit Committee. (The Charter for the NASD Audit Committee is available on the Internet at the following URL: *http://www.nasd.com/corp_info/audit_committee.asp*.)

During 2003, the Committee met 10 times, with the Committee members having a 96% attendance rate.

In discharging its oversight responsibility, the Audit Committee reviewed the assessments of audit risk and the audit plans of both the independent and internal auditors. The Audit Committee also discussed with management, the internal auditors, and the independent auditors the quality and adequacy of NASD’s internal controls and the internal audit organization, responsibilities, budget, and staffing.

The Audit Committee obtained a written statement from the independent auditors describing all relationships with NASD. The Audit Committee discussed those relationships and satisfied itself that none of the relationships were incompatible with the auditors’ independence. The Committee has reviewed and approved all services performed by NASD’s independent auditors, Ernst and Young, and the associated fees, before initiation of each engagement. Such services and fees are summarized in the following table:

INDEPENDENT PUBLIC ACCOUNTANT (IPA) FEES

	NASD		NASDAQ (5)		Amex		Total	
	2003 (6)	2002 (6)	2003	2002	2003 (6)	2002 (6)	2003 (6)	2002 (6)
Audit services (1)	$ 569,095	$425,800	$1,857,159	$2,048,072	$241,500	$187,700	$2,667,754	$2,661,572
Audit-related services (2)	417,176	369,913	191,200	1,933,753	49,275	61,642	657,651	2,365,308
Tax services (3)	55,000	187,573	435,325	286,471	–	32,032	490,325	506,076
Other services (4)	–	–	6,900	1,235,361	–	–	6,900	1,235,361
Total	$1,041,271	$983,286	$2,490,584	$5,503,657	$290,775	$281,374	$3,822,630	$6,768,317

(1) Audit services for NASD and Amex represent fees for the year end financial statement audits. Audit services for NASDAQ represent fees associated with the audit, inclusive of international entities, of NASDAQ's annual financial statements, the review of Nasdaq's quarterly reports on Form 10-Q, and accounting consultations on matters addressed during the audit or interim review.

(2) Audit-related services in 2003 and 2002 for NASD and Amex reflect fees associated with special purpose audits and agreed-upon procedures such as IARD, CRD, employee benefit plans, CTA/CQS Plans, as well as audit-related services associated with the planned disposition of Amex. NASDAQ audit-related services for 2003 represent assurance, employee benefit plan audits, and internal control reviews, including assistance with Section 404 internal control reporting. In 2002, NASDAQ's audit related services included transactional due diligence fees related to NASDAQ's global strategic initiatives of $1.9 million.

(3) Tax services represent fees related to tax compliance, advice, and planning.

(4) For 2003, other services for NASDAQ represent client advisory services and products. For 2002, other services for NASDAQ include fees associated with internal audit co-sourcing services of $1.2 million.

(5) NASDAQ IPA services and fees are separately reviewed and approved by the NASDAQ Audit Committee. The NASD Audit Committee has oversight of the NASDAQ Audit Committee, but does not review actions taken with respect to the approval of IPA fees.
(6) Fees included in 2002 were generally paid between July 1, 2002 and June 30, 2003, and have been updated from the prior year report to reflect final amounts paid for the 2002 approved services. NASD and Amex fees reported for 2003 are based on fees approved by NASD's Audit Committee as of June 7, 2004. The 2003 audit services and audit-related services include estimates to complete the 2003 audit for work in process, and unbilled, at the time this schedule was prepared.

The Audit Committee discussed and reviewed with the independent auditors all communications required by generally accepted auditing standards and, with and without management present, discussed the results of the independent auditors' examination of the financial statements. Based on those discussions, the Audit Committee recommended to the Board of Governors that NASD's audited financial statements be included in the Annual Report for the year ended December 31, 2003.

Members of the Audit Committee:

James E. Burton, Chairman
John W. Bachman
M. LaRae Bakerink
Charles A. Bowsher
Joel Seligman

June 7, 2004

REPORT OF INDEPENDENT AUDITORS

Board of Governors
National Association of Securities Dealers, Inc.

We have audited the accompanying consolidated balance sheets of the National Association of Securities Dealers, Inc. (NASD) as of December 31, 2003 and 2002, and the related consolidated statements of income, changes in members' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of NASD at December 31, 2003 and 2002, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

Ernst + Young LLP

McLean, Virginia
June 7, 2004, except for the last paragraph
of Note 17 as to which the date is
June 16, 2004

NASD

CONSOLIDATED BALANCE SHEETS (Dollars in thousands)

	December 31, 2003	2002
Assets		
Current assets:		
Cash and cash equivalents	**$ 332,784**	$ 332,029
Investments:		
Available-for-sale, at fair value	**1,309,307**	1,231,024
Held-to-maturity, at amortized cost	**23,765**	18,674
Receivables, net	**134,991**	185,417
Deferred tax assets	**40,460**	53,048
Other current assets	**22,728**	29,750
Current assets—discontinued operations	**120,511**	138,179
Total current assets	**1,984,546**	1,988,121
Held-to-maturity investments, at amortized cost	**4,506**	9,756
Property and equipment:		
Land, buildings and improvements	**169,216**	167,082
Data processing equipment and software	**529,522**	570,068
Furniture, equipment and leasehold improvements	**305,073**	323,124
	1,003,811	1,060,274
Less accumulated depreciation and amortization	**(605,661)**	(554,071)
Total property and equipment, net	**398,150**	506,203
Non-current deferred tax assets	**109,479**	93,152
Other assets	**39,557**	70,447
Non-current assets—discontinued operations	**32,785**	112,210
Total assets	**$2,569,023**	$2,779,889

See accompanying notes.

NASD

CONSOLIDATED BALANCE SHEETS (Dollars in thousands)

	December 31, 2003	2002
Liabilities and members' equity		
Current liabilities:		
Accounts payable and accrued expenses	**$ 73,065**	$ 99,280
Net SEC fees	**111,935**	60,526
Accrued personnel and benefit costs	**134,855**	111,392
Deferred revenue	**97,034**	101,218
Deposits and renewals	**67,220**	68,423
Capital lease obligation	**2,320**	3,545
Due to custodial agent	**124,973**	131,084
Other current liabilities	**118,754**	83,771
Current liabilities—discontinued operations	**102,924**	131,051
Total current liabilities	**833,080**	790,290
Accrued pension and other postretirement benefit costs	**41,307**	33,190
Long-term debt	**265,000**	415,000
Non-current deferred tax liabilities	**78,317**	75,701
Non-current capital lease obligation	**1,654**	5,877
Deferred revenue	**84,703**	102,065
Warrants to purchase NASDAQ stock from NASD	**7,744**	23,825
Other liabilities	**46,990**	32,256
Non-current liabilities—discontinued operations	**41,280**	72,221
Total liabilities	**1,400,075**	1,550,425
Minority interest	**12,034**	61,390
Minority interest of discontinued operations	**–**	(6,482)
Commitments and contingencies		
Members' equity	**1,120,191**	1,173,487
Unrealized gain on available-for-sale investments	**39,442**	5,374
Foreign currency translation	**875**	(217)
Minimum pension liability	**(3,594)**	(4,088)
Total members' equity	**1,156,914**	1,174,556
Total liabilities and members' equity	**$2,569,023**	$2,779,889

See accompanying notes.

NASD

CONSOLIDATED STATEMENTS OF INCOME (Dollars in thousands)

	Years ended December 31, 2003	2002
Revenues		
Transaction services	**$ 234,419**	$ 380,515
Market information	**160,425**	205,171
Issuer services	**167,312**	173,250
Member regulatory fees, net of member rebates of $25,000 in 2003 and $24,000 in 2002	**175,440**	177,471
Registration fees	**65,770**	69,617
Dispute resolution fees	**75,453**	59,589
Qualification fees	**40,387**	37,685
Corporate financing fees	**10,099**	10,454
Other	**64,868**	43,296
Total operating revenues	**994,173**	1,157,048
Fines	**33,329**	68,234
Total revenues	**1,027,502**	1,225,282
Expenses		
Compensation and benefits	**427,094**	417,092
Professional and contract services	**156,261**	194,973
Computer operations and data communications	**144,712**	156,382
Depreciation and amortization	**134,415**	143,168
Occupancy	**61,308**	56,982
Marketing and advertising	**24,462**	26,945
Publications, supplies and postage	**24,837**	26,354
Travel, meetings and training	**22,717**	25,821
Elimination of non-core product lines, initiatives and severance	**97,910**	–
NASDAQ Japan impairment (gain) loss	**(5,000)**	15,208
Other	**18,181**	40,768
Total expenses	**1,106,897**	1,103,693
Net operating (loss) income	**(79,395)**	121,589
Other income (expense)		
Interest and dividend income	**43,355**	51,228
Interest expense	**(18,702)**	(18,664)
Net realized investment gains (losses)	**24,327**	(49,014)
Gain on NASDAQ warrants	**16,080**	104,667
Net losses from equity investees	**(4,102)**	(12,065)
Minority interest benefit (expense)	**47,203**	(17,201)
Income before income taxes and discontinued operations	**28,766**	180,540
Benefit (provision) for income taxes	**21,240**	(40,921)
Income from continuing operations	**50,006**	139,619
Loss from discontinued operations (net of tax benefits of $12,494 in 2003 and $3,377 in 2002)	**(107,720)**	(143,099)
Net loss	**$ (57,714)**	$ (3,480)

See accompanying notes.

NASD

CONSOLIDATED STATEMENTS OF CHANGES IN MEMBERS' EQUITY (Dollars in thousands)

	Members' Equity	Accumulated Other Comprehensive Income (Loss)	Total
Balance, January 1, 2002	$1,054,164	$(12,130)	$1,042,034
Net loss	(3,480)	–	(3,480)
Unrealized gain on available-for-sale investments, net of tax of $1,158, net of minority interests of $745	–	11,843	11,843
Foreign currency translation, net of minority interests of $2,034	–	4,483	4,483
Minimum pension liability, net of tax of $1,659, net of minority interests of $58	–	(3,127)	(3,127)
Comprehensive income	–	–	9,719
Increase in equity attributable to the NASDAQ stock repurchase from NASD	122,947	–	122,947
Increase in equity attributable to the issuance of stock by NASDAQ and its subsidiaries, net of minority interest of $1,203	1,029	–	1,029
Decrease in equity attributable to the minority partners share of NASD's net contribution to NASDAQ	(2,260)	–	(2,260)
Adjustment to the carrying value of NASDAQ Europe due to the sale of securities to a third party, net of minority interest of $325	403	–	403
Increase in equity attributable to amortization of restricted stock awards by NASDAQ, net of minority interest of $1,366	684	–	684
Balance, December 31, 2002	**1,173,487**	**1,069**	**1,174,556**
Net loss	**(57,714)**		**(57,714)**
Unrealized gain on available-for-sale investments, net of tax of $340, net of minority interests of $340	**–**	**34,068**	**34,068**
Foreign currency translation, net of minority interests of $856	**–**	**1,092**	**1,092**
Minimum pension liability, net of tax of $191, net of minority interests of ($135)	**–**	**494**	**494**
Comprehensive loss	**–**	**–**	**(22,060)**
Increase in equity attributable to the minority interest in preferred stock dividends	**3,781**	**–**	**3,781**
Increase in equity attributable to the issuance of stock by NASDAQ and its subsidiaries, net of minority interest of $684	**791**	**–**	**791**
Decrease in equity attributable to amortization of restricted stock awards by NASDAQ, net of minority interest of $44	**(154)**	**–**	**(154)**
Balance, December 31, 2003	**$1,120,191**	**$ 36,723**	**$1,156,914**

See accompanying notes.

NASD

CONSOLIDATED STATEMENTS OF CASH FLOWS (Dollars in thousands)

	Years ended December 31, 2003	2002
Cash flows from operating activities		
Net loss	**$ (57,714)**	$ (3,480)
Net loss from discontinued operations	**(107,720)**	(143,099)
Income from continuing operations	**$ 50,006**	$ 139,619
Adjustments to reconcile net loss to cash provided by operating activities:		
Depreciation and amortization	**134,415**	143,168
Gain on NASDAQ warrants	**(16,080)**	(104,667)
Amortization of restricted stock and other stock-based compensation	**(50)**	3,155
Net realized (gains) losses on investments	**(25,358)**	15,327
Investment impairment charges	**1,031**	33,687
Elimination of non-core product lines and initiatives	**33,923**	–
Loss on disposal of fixed assets	**1,394**	23,248
NASDAQ Japan impairment (gain) loss	**(5,000)**	15,208
Losses from equity investees	**4,102**	12,065
Bad debts expense	**6,291**	13,009
Minority interest (benefit) expense	**(47,203)**	17,201
Other net non-cash income items	**12,823**	2,167
Net change in operating assets and liabilities:		
Receivables, net	**43,897**	29,138
Deferred tax assets	**(3,739)**	(397)
Other current assets	**4,201**	(6,651)
Other assets	**18,353**	(10,757)
Accounts payable and accrued expenses	**(26,215)**	(21,102)
Accrued personnel and benefit costs	**23,463**	6,962
Deferred revenue	**(21,546)**	(23,692)
Deposits and renewals	**(1,203)**	11,128
Due to custodial agent	**(6,111)**	103,157
Other current liabilities	**39,888**	36,866
Accrued pension and other post-retirement costs	**8,117**	(7,294)
Deferred tax liabilities	**2,616**	3,406
Other liabilities	**14,734**	(23,757)
Net cash provided by continuing operations	**246,749**	410,194
Cash used in discontinued operations	**(63,213)**	(87,868)
Net cash provided by operating activities	**183,536**	322,326

See accompanying notes.

CONSOLIDATED STATEMENTS OF CASH FLOWS (Dollars in thousands)

	Years ended December 31, 2003	2002
Cash flow from investing activities		
Proceeds from redemptions of available-for-sale investments	**6,207,468**	5,941,202
Purchases of available-for-sale investments	**(6,231,672)**	(6,298,395)
Proceeds from maturities of held-to-maturity investments	**18,600**	–
Purchases of held-to-maturity investments	**(18,453)**	–
Capital contribution to NASDAQ LIFFE joint venture	**(2,500)**	(16,000)
Purchases of property and equipment, net	**(50,667)**	(104,798)
Net cash used in investing activities	**(77,224)**	(477,991)
Cash flow from financing activities		
Net proceeds from the purchase of NASDAQ shares	**996**	2,238
Proceeds from issuance of debt	**–**	150,000
Debt repayment	**(150,000)**	–
Increase (decrease) in net SEC fees	**51,409**	(22,285)
Payments for treasury stock purchases by NASDAQ	**(147)**	–
Principal payments on capital leases	**(7,815)**	(3,275)
Net cash (used in) provided by financing activities	**(105,557)**	126,678
Increase (decrease) in cash and cash equivalents	**755**	(28,987)
Cash and cash equivalents at beginning of year	**332,029**	361,016
Cash and cash equivalents at end of year	**$ 332,784**	$ 332,029
SUPPLEMENTAL DISCLOSURES:		
Cash payments for interest	**$ 16,280**	$ 19,612
Cash payments for taxes, net of refunds	**$ (25,936)**	$ 77,187
SCHEDULE OF NONCASH INVESTING ACTIVITIES:		
Purchases of property and equipment under capital lease	**$ 2,367**	$ 225

See accompanying notes.

NASD

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND NATURE OF OPERATIONS

The National Association of Securities Dealers, Inc. (NASD), a Delaware corporation, is the majority owner of The Nasdaq Stock Market, Inc. (NASDAQ), and wholly owns the following significant subsidiaries: NASD Regulation, Inc. (NASDR), NASD Dispute Resolution, Inc. (NASD DR) and New NASD Holding, Inc. (NASD Holding); collectively referred to as the Company. NASD Holding holds NASD's Class B interest in The American Stock Exchange LLC (Amex).

NASD regulates the activities of the U.S. securities industry and regulates NASDAQ and the over-the-counter securities markets. NASDR carries out NASD's regulatory functions, including onsite examinations of securities firms, continuous automated surveillance of markets operated by NASDAQ, and disciplinary actions against firms and registered representatives. NASD DR provides arbitration and mediation services to assist in the resolution of monetary and business disputes between and among investors, securities firms, and registered representatives.

NASDAQ, the largest electronic screen-based equity securities market in the United States, uses a multiple market maker system to operate their market.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of NASD and majority owned subsidiaries. Investments in which the Company has the ability to exercise significant influence, but not control, are accounted for using the equity method. All significant intercompany balances and transactions have been eliminated in consolidation.

USE OF ESTIMATES

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

SEGMENTS

NASD operates in two primary business segments, NASD and NASDAQ, as defined by Statement of Financial Accounting Standards (SFAS) No. 131, "Disclosures About Segments of an Enterprise and Related Information." NASD's chief operating decision maker as defined by SFAS No. 131 is our Chief Executive Officer. The Company uses net operating income (loss) to evaluate performance of its business segments.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents include demand cash and all non-restricted investments purchased with a remaining maturity of three months or less at the time of purchase.

INVESTMENTS

Under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," management determines the appropriate classification of investments at the time of purchase. Investments for which the Company does not have the intent or

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

ability to hold to maturity are classified as "available-for-sale" and are carried at fair value, with any unrealized gains and losses, net of tax, reported as a separate component of members' equity. Investments for which the Company has the intent and ability to hold to maturity are classified as "held-to-maturity" and are carried at amortized cost. The amortized cost of debt securities classified as held-to-maturity is adjusted for amortization of premiums and accretion of discounts. Realized gains and losses on sales of securities are included in earnings using the average cost method. Amounts due to or from the custodial agent relate to security trades executed prior to the balance sheet date but not yet settled.

Available-for-sale investments also include investments in auction rate securities, which are either preferred stock or bonds with interest rates that reset periodically, typically less than every 90 days, based on a Dutch auction process. Given the longer-term maturities of these securities, they are classified as available-for-sale investments.

The Company reviews its investments quarterly to determine whether a decline in fair value below the cost basis is other-than-temporary. If the decline in the fair value is judged to be other-than-temporary, the cost basis of the investment is written down to fair value, the amount of the write-down is charged to earnings, and a new cost basis for the security is established. For the years ended December 31, 2003 and 2002, the Company recorded charges of $1.0 million and $33.7 million, respectively, related to declines in the fair value of its investments that were judged to be other-than-temporary. This write down is reflected in the net realized investment gains (losses) in the consolidated statements of income.

DERIVATIVE INSTRUMENTS

The Company accounts for freestanding and embedded derivative instruments in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities." SFAS No. 133, as amended and interpreted, establishes accounting and reporting standards for derivative instruments and requires that all derivatives be recorded on the balance sheet at fair value. Additionally, the accounting for changes in fair value depends on whether the derivative instrument is designated and qualifies as part of a hedging relationship and, if so, the nature of the hedging activity. Changes in the fair value of derivatives that do not qualify for hedge treatment are recognized currently in earnings.

The Company places the majority of its investment funds with outside investment managers. The Company reviews its investment portfolio against the provisions of SFAS No. 133, as amended and interpreted, to identify any investment products that may have characteristics that qualify the investment as a derivative instrument. Certain available-for-sale investments held by the Company represented either freestanding derivatives or contained embedded derivatives. As of December 31, 2003 and 2002, the fair value of these derivative instruments was insignificant.

As discussed in Note 3, "Significant Transactions," NASD issued 10.8 million warrants for the purchase of 43.2 million shares of NASDAQ common stock. Prior to July 2002, NASD accounted for the warrants at the amount of net proceeds received. Beginning in July 2002, NASDAQ common stock began trading on an over-the-counter market. Further, all transfer restrictions related to the common stock had expired. Therefore, beginning in July 2002, NASD began accounting for these warrants as derivative instruments in accordance with the provisions of SFAS No. 133, as amended and interpreted. These warrants are carried at fair value with changes in the fair value recorded in income, which resulted in a gain of $16.1 million and $104.7 million for the years ended December 31, 2003 and 2002, respectively. Fair value of these warrants is determined using a Black-Scholes valuation model with a weighted-average expected life of 2.1 years and 2.6 years for 2003 and 2002, respectively, a weighted-average expected volatility of 30%, and a weighted-average risk free interest rate of 1.31% and 1.44% for 2003 and 2002, respectively.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

RECEIVABLES, NET

The Company's receivables are primarily concentrated with NASD members, market data vendors and NASDAQ listed companies. Receivables are shown net of reserves for uncollectible accounts. Reserves are calculated based on the age and source of the underlying receivable and are tied to past collections experience. Total reserves netted against receivables in the consolidated balance sheets were $3.9 million and $8.3 million at December 31, 2003 and 2002, respectively. The Company determines write-offs to the reserve based on collection history and specific risks identified on a customer-by-customer basis. Receivables greater than 120 days outstanding are reviewed individually for collectibility.

CONCENTRATION OF RISK

Financial instruments that potentially subject the Company to concentrations of risk consist primarily of cash and cash equivalents, available-for-sale and held-to-maturity investments, and accounts receivable. The Company does not require collateral on these financial instruments.

Cash and cash equivalents are maintained principally with financial institutions located in the United States, which have high credit ratings. Risk on accounts receivable is reduced by the large number of entities comprising the Company's customer base and through ongoing evaluation of collectibility of amounts owed to the Company. NASD uses multiple outside investment managers to manage its investment portfolio and a custody agent, a publicly traded company located in New York, to hold and report on investments.

The Company is economically dependent on two suppliers, which provide telecommunications and information technology services to the Company. One of these two suppliers has recently emerged from bankruptcy. To the extent either of these suppliers is not able to perform, it could have an adverse effect on the Company's business.

The Company's business is transacted with multiple customers, with no individual customer exceeding 10% of total revenues.

PROPERTY AND EQUIPMENT

Property and equipment are recorded at cost less accumulated depreciation. Equipment acquired under capital leases is recorded at the lower of fair value or the present value of future lease payments. Repairs and maintenance costs are expensed as incurred. Depreciation and amortization are provided using the straight-line method over estimated useful lives ranging from ten years to forty years for buildings and improvements, two years to seven years for data processing equipment and software, and five years to ten years for furniture and equipment. Leasehold improvements are amortized using the straight-line method over the lesser of the useful life of the improvement or the term of the applicable lease. Depreciation and amortization expense for property and equipment, which includes capitalized software costs, totaled $125.9 million and $136.7 million for the years ended December 31, 2003 and 2002, respectively.

Property and equipment includes capital leases of $8.8 million and $14.6 million, and accumulated amortization of $4.8 million and $5.1 million, for the years ended December 31, 2003 and 2002, respectively. Amortization of assets under capital lease was $6.7 million and $3.6 million for the years ended December 31, 2003 and 2002, respectively, and is included within depreciation and amortization expense in the consolidated statements of income.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill represents the excess of purchase price and related costs over the value assigned to the net tangible and identifiable intangible assets of businesses acquired. As a result of the adoption of SFAS No. 142, "Goodwill and Other Intangible Assets," in the first quarter of fiscal year 2002, goodwill and certain intangibles will no longer be amortized, but instead tested for impairment at least annually. The Company evaluates the recoverability of intangible assets and takes into account events or circumstances that warrant revised estimates of useful lives or that indicate impairment exists. As of December 31, 2003 and 2002, goodwill and other intangibles were $4.9 million and $15.6 million, respectively, and are included within other assets in the consolidated balance sheets. Other intangible asset amortization expense was $1.8 million and $2.9 million for the years ended December 31, 2003 and 2002, respectively, and is included within depreciation and amortization expense in the consolidated statements of income.

IMPAIRMENT OF LONG-LIVED ASSETS

The Company reviews its long-lived assets for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long Lived Assets." In the event facts and circumstances indicate that long-lived assets or other assets may be impaired, an evaluation of recoverability would be performed. If an evaluation were required, the estimated future undiscounted cash flows associated with the asset would be compared to the asset's carrying amount to determine if a write-down is required. If impairment were indicated, the Company would prepare a discounted cash flow analysis to determine the amount of the impairment.

During the fourth quarter of 2003, NASDAQ recognized a $12.3 million impairment charge on the video wall on the MarketSite Tower at its Times Square, New York location, based on a significant adverse change in the extent and manner in which the Tower portion of the MarketSite was used. See Note 3, "Significant Transactions," for additional information.

NET SEC FEES

NASD collects a fee based on a percentage of the total dollar value of securities sold in The Nasdaq Stock Market. These fees are designed to cover costs incurred by the government in the supervision and regulation of securities markets and securities professionals. NASD collects these fees from securities firms and remits them to the U.S. Treasury semiannually in March and September. The liability for net SEC fees represents amounts collected from firms but not yet remitted to the U.S. Treasury.

DEFERRED REVENUE

Deferred revenue represents cash received and billed receivables, which are unearned until services are provided. Included in deferred revenue are unamortized initial listing fees (IL) and listing of additional shares fees (LAS). The Company recognizes revenue related to IL fees and LAS fees on a straight-line basis over estimated service periods. Estimated service periods for IL fees are six years, while LAS fees are recognized over a four-year service period.

DEPOSITS AND RENEWALS

NASD-registered firms make deposits into the Company's Central Registration Depository (CRD) system to pay for services including registration fees charged by states and other self-regulatory organizations. Total CRD related deposits and renewals were $47.9 million and $52.6 million as of December 31, 2003 and 2002, respectively.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

In February 2002, NASD DR was approached by the District Attorney of the County of New York to administer a fund of monies collected as a result of dispositions in a case in which investors were harmed by actions taken by a firm, which was being prosecuted by the District Attorney's Office. This fund, overseen by the North American Securities Administrators Association, was set up to distribute these monies to the claimants in a fair and efficient way. The total deposits related to this fund were $16.5 million and $13.3 million as of December 31, 2003 and 2002, respectively.

REVENUE RECOGNITION

Operating Revenues

Market information revenues for NASD are based on secondary market transactions in eligible fixed income securities reported to NASD. Market information revenues for NASDAQ are based on the number of presentation devices in service and market data information quotes delivered through those devices. These revenues are recorded net of amounts due under revenue sharing arrangements with market participants. Market information revenues are recognized in the month that information is provided. Transaction service, regulatory service fees, registration fees and qualification fees are variable based on service volumes and are recognized as transactions occur. Member regulatory fees on NASD-regulated firms are recognized evenly over the year to which the fee relates and are recorded net of any rebates paid to firms. Initial registration fees for members are recognized once the registration process is completed. Issuer services consist primarily of annual listing fees, IL fees and LAS fees. Annual listing service revenues are recognized ratably over the following 12-month period. IL and LAS fees are recognized on a straight-line basis over their estimated service periods (see Note 4, "Deferred Revenue"). Dispute resolution fees on open cases are recognized as revenue when cash is received. When a case is closed and the final billings are prepared, any unpaid fees are recognized as revenue.

Effective June 1, 2002, NASDAQ terminated its market data revenue sharing program for securities listed on The Nasdaq Stock Market, as a result of the SEC's decision to abrogate certain market participant tape sharing pilot programs. The SEC's action was in response to concerns about the effect of market data rebates on the accuracy of market data and the regulatory functions of self-regulatory organizations. The SEC's action allows NASDAQ and competing exchanges to retain tape revenue. NASDAQ continues to share market data revenue with the exchanges that participate in the unlisted trading privileges plan based on their respective share volume and trades of securities listed on The Nasdaq Stock Market. In addition, NASDAQ InterMarket continues to share tape revenue with NASDAQ market participants who report trades in the New York Stock Exchange (NYSE) and Amex listed securities through NASDAQ.

In August 2003, NASDAQ filed with the SEC on an immediately effective basis, a NASDAQ general revenue sharing program, which like The National Stock Exchange's general revenue sharing program, shares operating revenue from multiple business lines in addition to tape fee revenue. The new program shares operating revenue, which is interpreted to mean net revenue after expenses from all services that derive revenue from member trading and trade-reporting activity in NASDAQ-listed securities. As such, the program will provide an incentive for quoting market participants to send orders to NASDAQ Market Center and report trades to ACT. NASDAQ did not share any revenues during 2003, but began sharing revenues under this program in January 2004.

Fines

Fines are recognized when the cash is received. In January 2002, NASDR censured a large investment banking firm and directed it to pay $50.0 million to the SEC and $50.0 million to NASDR in monetary sanctions for receiving inflated commissions in what

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

amounted to profit-sharing arrangements on initial public offerings (IPO) serviced by that firm. In January 2003, NASDR censured another large investment banking firm and directed it to pay $14.0 million to the SEC and $14.0 million to NASDR in monetary sanctions for receiving inflated commissions from more than 100 client accounts in exchange for the allocation of "hot" IPOs in 1999 and 2000. In February 2004, 15 firms were censured by NASDR and directed to pay $11.2 million to NASDR in monetary sanctions for failure to deliver mutual fund breakpoint discounts during 2001 and 2002 (a subset of those firms were also sanctioned by the SEC). In March 2004, NASDR censured an investment banking firm and directed it to pay $10.0 million to NASDR in monetary sanctions for improperly extending credit to customers in violation of federal securities laws. In May 2004, NASDR censured three major investment banks and directed them to pay $15.0 million for engaging in improper IPO allocation practices.

SOFTWARE COSTS

Significant purchased application software, and operational software that is an integral part of computer hardware, are capitalized and amortized using the straight-line method over their estimated useful lives, generally two to seven years. All other purchased software is charged to expense as incurred. In accordance with Statement of Position (SOP) No. 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," the Company capitalizes internal computer software development costs incurred during the application development stage. Computer software costs incurred prior to or subsequent to the application development stage are charged to expense as incurred.

Unamortized capitalized software development costs of $102.8 million and $112.8 million as of December 31, 2003 and 2002, respectively, are carried within data processing equipment and software in the consolidated balance sheets. Amortization of costs capitalized under SOP No. 98-1 totaled $28.3 million and $23.2 million for 2003 and 2002, respectively, and is included in depreciation and amortization in the consolidated statements of income. Additions to capitalized software were $18.9 million and $36.7 million in 2003 and 2002, respectively.

SFAS No. 34, "Capitalization of Interest Cost," requires the capitalization of interest as part of the historical cost of acquiring assets, for all costs incurred to get the assets ready for their internal use. SOP No. 98-1 includes interest costs incurred while developing internal-use software as capitalizable costs under SFAS No. 34. The effect of capitalization of interest cost related to the development of internal-use software is not material when compared with the effect of expensing these interest costs as incurred. Therefore, all interest costs have been expensed when incurred.

ADVERTISING COSTS

The Company expenses advertising costs, which include media advertising and production costs. Advertising costs are recorded in the period in which the costs are incurred. Media advertising and production costs included as marketing and advertising in the consolidated statements of income totaled $13.6 million and $13.3 million for 2003 and 2002, respectively. The remainder of marketing and advertising expenses represents costs associated with direct marketing, event sponsorships, and conferences.

PENSION BENEFITS

The Company accounts for pension plans in accordance with SFAS No. 87, "Employers Accounting for Pensions." Unrecognized actuarial gains and losses arise from several factors including experience and assumption changes in the obligations, and from the difference between expected returns and actual returns on plan assets.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The Company provides two non-contributory defined benefit pension plans for the benefit of eligible employees of its subsidiaries. The non-contributory defined benefit plans consists of a funded Employee Retirement Plan (ERP) and an unfunded Supplemental Executive Retirement Plan (SERP).

STOCK COMPENSATION

NASD's consolidated subsidiary, NASDAQ, maintains a stock compensation plan for its employees. NASDAQ accounts for stock option grants in accordance with Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees." NASDAQ grants stock options with an exercise price equal to the fair market value of the stock at the date of the grant, and accordingly, recognizes no compensation expense related to such grants.

In the first quarter of 2003, NASDAQ adopted SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure." SFAS No. 148 amends the disclosure requirements of SFAS No. 123, "Accounting for Stock-Based Compensation." Pro forma net income includes the amortization of the fair value of stock options over the vesting period and the difference between the fair value and the purchase price of common shares purchased by employees under the employee stock purchase plan. The pro forma income from continuing operations for the years ended December 31, 2003 and 2002 was $42.9 million and $135.2 million, respectively. See Note 11, "NASDAQ Stock Compensation, Stock Awards and Capital Stock," for additional information.

INCOME TAXES

NASD, NASDR, and NASD DR are tax-exempt organizations under the Internal Revenue Code (IRC) Section 501(c)(6). All other consolidated subsidiaries of NASD are taxable entities. Deferred tax assets and liabilities are determined based on differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities (i.e., temporary differences) and are measured at the enacted rates that will be in effect when these differences are realized. If necessary, a valuation allowance is established to reduce deferred tax assets to the amount that is more likely than not to be realized.

ISSUANCE OF SUBSIDIARY STOCK

The Company recognizes gains and losses on issuances of subsidiary stock in members' equity.

FOREIGN CURRENCY TRANSLATION

Assets and liabilities of non-U.S. subsidiaries that operate in a local currency environment are translated to U.S. dollars at exchange rates in effect at the balance sheet date. Revenues and expenses are translated at average exchange rates during the year. Translation adjustments resulting from this process are charged or credited to other comprehensive income. Foreign currency translation also includes the translation of gains and losses for non-U.S. equity method investments.

MINORITY INTERESTS

Minority interests in the consolidated balance sheets represent the minority owners' share of equity of consolidated subsidiaries, principally NASDAQ, as of the balance sheet date. Minority interests in the consolidated statements of income represent the minority owners' share of the income or loss of consolidated subsidiaries.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

RECENT ACCOUNTING PRONOUNCEMENTS

In May 2003 the Financial Accounting Standards Board (FASB) issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity," which provides guidance on the reporting of various types of financial instruments as liabilities or equity. This statement is effective for instruments entered into or modified after May 31, 2003 and is effective for pre-existing instruments beginning July 1, 2003. The adoption of SFAS No. 150 did not have a material impact on the Company's consolidated earnings or financial position.

In January 2003 the FASB issued FASB Interpretation (FIN) No. 46, "Consolidation of Variable Interest Entities—an interpretation of ARB No. 51." This interpretation addresses consolidation of business enterprises of variable interest entities (VIEs), which have certain characteristics. These characteristics include either that the equity investment at risk is not sufficient to permit the entity to finance its activities without subordinated financial support from other parties, or that the equity investors in the entity lack one or more of the essential characteristics of a controlling financial interest. FIN No. 46 establishes consolidation criteria for entities for which "control" is not easily discernable under Accounting Research Bulletin No. 51, "Consolidated Financial Statements," which is based on the premise that holders of the equity of an entity control the entity by virtue of voting rights. FIN No. 46 provides guidance for identifying the party with a controlling financial interest resulting from arrangements or financial interests rather than from voting interests. In December 2003 the FASB announced an amendment to FIN No. 46 entitled FASB Interpretation No. 46R, "Consolidation of Variable Interest Entities." FIN No. 46 (Revised 2003) partially deferred the effective date of FIN No. 46 for certain entities, and makes several other major changes to FIN No. 46, which include an improved definition of variable interest, and an exemption for many entities defined as businesses in the interpretation. FIN No. 46 (Revised) becomes effective during the first quarter of 2004. The Company does not believe adoption of FIN No. 46 (Revised) will have a material impact on the Company's consolidated earnings or financial position.

In November 2002 the FASB issued FIN No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN No. 45 provides accounting and disclosure requirements for certain guarantees. The interpretation requires certain guarantees to be recorded at fair value versus the current practice of recording a liability only when a loss is probable and reasonably estimable. The accounting provisions of FIN No. 45 are effective for certain guarantees issued or modified beginning January 1, 2003. Adoption of this interpretation did not have a material impact on the Company's consolidated earnings or financial position.

In July 2002 the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." This statement is effective for exit or disposal activities initiated after December 31, 2002, and generally requires costs associated with exit or disposal activities (including costs related to involuntary terminations and contract termination costs) to be recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. Specifically, costs associated with involuntary terminations are to be accrued on the date the employees are notified, assuming the period of time between the notification date and termination date is the lesser of 60 days or the legally required notification period. Otherwise, these costs are to be recognized evenly over the period from notification to termination. Contract termination costs are to be recognized when the contract is legally terminated or when the economic benefits of the contract are no longer being utilized. The Company is in accordance with SFAS No. 146 for the elimination of all non-core products, initiatives, and severance incurred during 2003.

RECLASSIFICATIONS

Certain amounts for the prior year have been reclassified to conform to the 2003 presentation.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. SIGNIFICANT TRANSACTIONS

NASDAQ RESTRUCTURING

At a special meeting of NASD members on April 14, 2000, more than a majority of NASD members approved a plan to broaden the ownership in NASDAQ through a two-phase private placement of (1) newly-issued shares of NASDAQ common stock, and (2) common stock and warrants to purchase shares of NASDAQ common stock owned by NASD (the "Restructuring"), to NASD members, NASDAQ market participants, NASDAQ issuers, institutional investors and other strategic partners. The Restructuring was intended, among other things, to strategically realign the ownership of NASDAQ, minimize potential conflicts of interest between NASDAQ and NASDR, and allow NASDAQ to respond to current and future competitive challenges caused by technological advances and the increasing globalization of financial markets.

In connection with Phase I of the Restructuring, (1) NASD separated Amex from NASDAQ-Amex Market Group, Inc. (Market Group), a holding company which was a subsidiary of NASD; (2) Market Group was then merged with and into NASDAQ; (3) NASDAQ effected a 49,999-for-one stock dividend creating 100.0 million shares of Common Stock outstanding (all of which were initially owned by NASD); (4) NASDAQ authorized the issuance of an additional 30.9 million in new shares to be offered for sale by NASDAQ; and (5) NASD formed a new subsidiary, NASD Holding, to hold NASD's interest in Amex.

Phase I and Phase II of the Restructuring closed on June 28, 2000 and January 17, 2001, respectively. The restructurings resulted in the following: (1) NASD sold 4.5 million of NASD-owned common shares of NASDAQ generating net proceeds of $57.0 million and recorded a gain of $33.7 million; (2) NASD sold 10.8 million warrants to purchase an aggregate of 43.2 million NASD-owned common shares of NASDAQ generating net proceeds to NASD of $128.6 million; and (3) NASDAQ sold 28.7 million newly issued common shares generating net proceeds to NASDAQ of $317.0 million. NASD received a ruling from the Internal Revenue Service (IRS) stating that the sale of NASDAQ shares and warrants did not result in taxable income to NASD.

Each warrant sold by NASD during Phase I and Phase II of the Restructuring entitles the holder to purchase four shares of NASDAQ common stock owned and held by NASD for prices ranging from $13.00 to $16.00 per share. Each warrant is exercisable for 12 months in each of four annual tranches, with one share of NASDAQ common stock available for purchase in each tranche. For the years ended December 31, 2003 and 2002, 15,000 and 20,830 warrants were exercised and 15,000 and 20,830 shares of voting trust certificates were issued from warrant exercises, yielding gross proceeds to NASD of $0.2 million and $0.3 million, respectively. The first annual tranche expired on June 27, 2003, upon which 10.8 million shares of common stock reverted back to NASD, representing common stock underlying the unexercised warrants. The second annual tranche became exercisable June 30, 2003. As of December 31, 2003 NASD held 43.2 million shares of NASDAQ common stock, of which 32.4 million underly the outstanding warrants. As of December 31, 2002, NASD held 43.2 million shares of common stock, all of which underly the outstanding warrants.

On March 8, 2002, NASDAQ completed a two-stage repurchase of 33.8 million shares of its common stock owned by NASD, which represented all of the remaining outstanding shares of NASDAQ common stock owned by NASD, except for the 43.2 million shares of NASDAQ common stock underlying the warrants. NASDAQ purchased the NASDAQ common stock for $305.2 million in aggregate cash consideration, 1.3 million shares of NASDAQ's Series A Cumulative Preferred Stock (face and liquidation value of $100 per share, plus any accumulated unpaid dividends), and one share of NASDAQ's Series B Preferred Stock, (face and liquidation value of $1.00 per share). With this transaction, total combined proceeds to NASD of $439.0 million resulted in NASD realizing proceeds in excess of its basis in the underlying shares of NASDAQ of $277.5 million. In addition, as a result of the reduction in NASDAQ equity from this transaction, NASD realized a reduction in its proportionate remaining ownership of NASDAQ of $154.6 million. Accordingly, the net effect of this transaction is reflected as a $122.9 million increase in the consolidated statement of changes in members' equity in 2002.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. SIGNIFICANT TRANSACTIONS (continued)

The Series A Cumulative Preferred Stock carries a 7.6% annual dividend rate, which began accruing in March 2003 and increases to an annual dividend rate of 10.6%, beginning in March 2004. The annual dividends are payable at the discretion of NASDAQ's Board of Directors. Shares of Series A Preferred Stock do not have voting rights, except for the right as a class to elect two new directors to the Board of Directors any time distributions on the Series A Preferred Stock are in arrears for four consecutive quarters and as otherwise required by Delaware law. The Series B Preferred Stock does not pay dividends. The Series B Preferred Stock entitles NASD to cast the number of votes that, together with all other votes that NASD is entitled to vote by virtue of ownership, proxies or voting trusts, enables NASD to cast one vote more than one-half of all votes entitled to be cast by stockholders. If NASDAQ's registration as an exchange is approved by the SEC and becomes effective (Exchange Registration), the share of Series B Preferred Stock will lose its voting rights and will be redeemed by NASDAQ. NASDAQ may redeem the shares of Series A Preferred Stock at any time after Exchange Registration and is required to use the net proceeds from an IPO, and upon the occurrence of certain other events, to redeem all or a portion of the Series A Preferred Stock.

If NASDAQ's obtains Exchange Registration, the shares of NASDAQ common stock underlying unexercised and unexpired warrant tranches, as well as the shares of NASDAQ voting trust certificates purchased through the exercise of warrants, will be voted by a voting trustee at the direction of NASD. If Exchange Registration is approved, the warrant holders will have the right to direct the voting trustee as to the voting of the shares of NASDAQ common stock underlying unexercised and unexpired warrant tranches. Additionally, NASD has determined, commencing upon Exchange Registration, to vote its shares of NASDAQ common stock (other than shares underlying then outstanding warrants) in the same proportion as the other common stockholders of NASDAQ.

As a result of these conditions, NASD has a controlling interest in NASDAQ until Exchange Registration is effective. As of December 31, 2003, the Exchange Registration has not become effective.

NASDAQ STRATEGIC REVIEW

During the second quarter of 2003, NASDAQ announced the results of a strategic review of its operations designed to position NASDAQ for improved profitability and growth. This strategic review included the elimination of non-core products and initiatives and resulted in a reduction in NASDAQ's workforce. For the year ended December 31, 2003, NASDAQ recorded total pre-tax charge of $145.5 million, including $97.9 million in costs associated with continuing operations and $47.6 million related to discontinued operations. The net impact to NASDAQ was a total pre-tax charge of $143.5 million. The difference represented costs absorbed by minority shareholders of NASDAQ Europe. See Note 15, "Discontinued Operations," for additional information related to discontinued operations. The charge recorded reflects the completion of the costs associated with NASDAQ's strategic review. The charge was primarily recorded to property and equipment, goodwill, other intangible assets, other accrued liabilities and accrued personnel costs on the consolidated balance sheets.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. SIGNIFICANT TRANSACTIONS (continued)

The following table summarizes the strategic review charges included in the consolidated statements of income for the year ended December 31, 2003 (see Note 15, "Discontinued Operations").

	(in millions)
Non-Core Product Lines and Initiatives:	
Impairment of capitalized software and fixed assets	$21.1
Impairment of goodwill and intangible assets	8.2
Contract cancellations	11.4
Other exit costs	11.6
Total non-core product lines and initiatives	52.3
Severance and benefit costs	32.4
Loss on early extinguishment of debt	13.2
Total strategic review charge	$97.9

Non-core product lines and initiatives included in the strategic review were:

- Primex—Primex was an electronic auction system. NASDAQ ended its exclusive rights agreement with Primex Trading N.A., L.L.C., on December 31, 2003. NASDAQ decided to consolidate its trading services to a common functionality within the NASDAQ Market Center system and ceased offering Primex effective January 16, 2004.

- NASDAQ Tools—NASDAQ Tools was an order management system that ran on the NASDAQ Application Programming Interface using the NASDAQ Workstation II and was wound-down throughout 2003. NASDAQ Tools was a previously wholly owned subsidiary of NASDAQ and was merged with and into NASDAQ on July 31, 2002.

- NASDAQ LIFFE Markets, LLC (NQLX)—NQLX was a joint venture with the London International Financial Futures Exchange (LIFFE) to create a market for single stock futures and other futures products. On July 24, 2003, NASDAQ redeemed its interest in the NQLX joint venture and transferred its ownership interest to LIFFE. LIFFE assumed financial and management responsibility for NQLX. This change did not have any impact on the operation of NQLX, but usage of the NASDAQ brand by the company ceased.

- The Bulletin Board Exchange (BBX)—BBX was a proposed platform for companies not eligible for the NASDAQ SmallCap Market to raise equity capital and increase the visibility of their stock.

- Liquidity Tracker—Liquidity Tracker was an automated order routing system designed to allow traders to direct orders to specific market makers based on recent trading activity. Liquidity Tracker ceased operations as of June 30, 2003.

- MarketSite Tower—MarketSite Tower is located at NASDAQ's Times Square, New York location. The video wall portion of the Tower was deemed impaired.

The charge related to the elimination of the above non-core products and initiatives was approximately $52.3 million for the year ended December 31, 2003. Included in the charge was the reduction of NASDAQ's investment in NQLX of $6.3 million due to the

3. SIGNIFICANT TRANSACTIONS (continued)

redemption of NASDAQ's interest in the NQLX joint venture, the impairment of goodwill of $4.1 million associated with NASDAQ Tools, the impairment of certain intangible assets of $4.1 million, impairment of various capitalized software and fixed assets of $21.1 million, contract cancellations of $11.4 million and other costs of $5.3 million. Included in the $21.1 million impairment of various capitalized software and fixed assets is $12.3 million of impairment on the MarketSite Tower. The remaining impairment of capitalized software and fixed assets relates to the eliminated products specifically, NASDAQ Tools, Primex, BBX and Liquidity Tracker.

The $12.3 million impairment on the MarketSite Tower was recorded based on significant adverse change in the extent and manner in which the Tower portion of the MarketSite was used. In earlier years, the Tower portion of the MarketSite generated revenues from advertising. However, in the economic downturn that followed September 11, 2001 and the market drop in the technology sector, the revenues from the Tower began to decline steeply and the Tower operated at a significant loss. NASDAQ's new executive management team was put in place in May 2003 and tried to find alternatives and other strategic uses for the video wall, however in the 4th quarter 2003, it was determined the Tower would never generate the originally forecasted amounts as the modules that make up the sign are considered outdated and the Tower faces competition from newer advertising technology. NASDAQ obtained a quoted market price valuation from an independent third party and recognized the excess of the carrying amount over the fair value as an impairment charge.

In addition, the strategic review charges included severance costs of $32.4 million and the loss on early extinguishment of long-term debt of $13.2 million. The severance costs included $13.8 million related to the reductions in force of 329 employees. The remaining $18.6 million of severance costs relate to the fulfillment of employment contracts and obligations associated with the retirement and departure of certain members of senior management. Total headcount was 956 as of December 31, 2003 versus 1,227 as of December 31, 2002. The extinguishment of debt costs relate to the redemption of $150.0 million in aggregate principal amount of NASDAQ's 5.83% Senior Notes due 2007 (the "Senior Notes") (see Note 8, "Borrowings"). In conjunction with its strategic review, NASDAQ reassessed its capital needs and determined that it no longer needed the liquidity of the Senior Notes.

The following table summarizes the strategic review accrual activity from initiation of NASDAQ's activities through December 31, 2003. Note that such accruals are recorded to other accrued liabilities and accrued personnel and benefit costs in the current liabilities section and to other liabilities in the consolidated balance sheets. NASDAQ expects to fund the majority of these reserves by the end of 2004.

	Severance for U.S. Employees	Products and Other	Total
	(in millions)		
Charges	$ 32.4	$14.7	$ 47.1
Cash payments	(15.7)	(3.7)	(19.4)
Other	(0.3)	(0.3)	(0.6)
Accrued liabilities associated with the strategic review as of December 31, 2003	$ 16.4	$10.7	$ 27.1

NASDAQ JAPAN

During the second quarter of 2002, NASDAQ recognized an other-than-temporary impairment charge on its equity investment in NASDAQ Japan. NASDAQ recognized this impairment as a result of the depressed level of market activity in Japan, combined with

3. SIGNIFICANT TRANSACTIONS (continued)

the suspension of NASDAQ Japan's hybrid trading system due to the inability to gain exchange approval of market rules and industry participation. These conditions led management to conclude that NASDAQ Japan would not be profitable in the foreseeable future. As a result, NASDAQ Japan's financial liabilities to NASDAQ were not expected to be repaid and were recognized as a loss.

The net impact of the other-than-temporary impairment on NASDAQ's pre-tax income was $15.2 million. This represented a complete write-down of the investment, outstanding and unfunded loans (an additional $6.0 million was loaned and $7.0 million was committed), foreign exchange translation losses and other receivables, partially offset by a re-valuation of certain variable NASDAQ Japan stock based awards of approximately $7.9 million.

On August 16, 2002, the Board of Directors of NASDAQ Japan voted to take the company to dormant status, effectively ceasing operations. After careful consideration, NASDAQ Japan's Board concluded that under the economic circumstances there was not a profitable path forward for the company. NASDAQ Japan entered into liquidation status in late November 2002 and was completely dissolved by the end of May 2003. Companies listed on the NASDAQ Japan Market retained their listing on the Osaka Exchange and experienced no disruption to trading.

During the second quarter of 2003, NASDAQ reversed $5.0 million of the reserves related to NASDAQ Japan due to favorable contract negotiations and lower legal costs resulting from the complete liquidation of NASDAQ Japan.

4. DEFERRED REVENUE

NASD

As of December 31, 2003 and 2002, NASD had deferred revenues of $37.4 million and $36.6 million, respectively, which is included within current deferred revenues in the consolidated balance sheets. During the fourth quarter of each year, NASD completes their annual renewal process for all registered representatives and member firm branch offices. These renewals relate to the following fiscal year, the period over which they are recognized into income. For the year ended December 31, 2003, NASD recognized revenues of $29.9 million and $6.7 million, which are in registration fees and member regulatory fees in the consolidated statements of income, respectively. For the year ended December 31, 2002, NASD recognized revenues of $21.3 million and $13.2 million, which are included in registration fees and member regulatory fees in the consolidated statements of income, respectively.

NASDAQ

NASDAQ accounts for issuer service revenues in accordance with Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements." NASDAQ recognizes revenue related to IL fees and LAS fees on a straight-line basis over estimated service periods. Estimated service periods for IL fees are six years, while LAS fees are recognized over a four-year service period.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. DEFERRED REVENUE (continued)

Following is a summary of amounts included in NASDAQ's current and non-current deferred revenue as of December 31, 2003, and the years over which those amounts will be recognized:

	IL	LAS	Total
	(in thousands)		
2004	$29,089	$30,650	$ 59,739
2005	22,759	20,764	43,523
2006	12,572	10,407	22,979
2007	7,549	4,136	11,685
2008 and thereafter	6,516	–	6,516
Total	$78,485	$65,957	$144,442

Following is a summary of activity in NASDAQ's current and non-current deferred revenue for the years ended December 31, 2003 and 2002. The additions reflect the fees charged during the year while the amortization reflects the fees recognized during the year based on the accounting methodology described above.

	IL	LAS	Annual and Other	Total
	(in thousands)			
Balance as of January 1, 2003	**$ 93,857**	**$ 72,841**	**$ –**	**$ 166,698**
Additions	**16,886**	**30,206**	**97,964**	**145,056**
Amortization	**(32,258)**	**(37,090)**	**(97,964)**	**(167,312)**
Balance as of December 31, 2003	**$ 78,485**	**$ 65,957**	**$ –**	**$ 144,442**

	IL	LAS	Annual and Other	Total
	(in thousands)			
Balance as of January 1, 2002	$104,629	$ 82,424	$ –	$ 187,053
Additions	22,840	27,948	102,107	152,895
Amortization	(33,612)	(37,531)	(102,107)	(173,250)
Balance as of December 31, 2002	$ 93,857	$ 72,841	$ –	$ 166,698

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. INVESTMENTS

Investments principally consist of U.S. Treasury securities, obligations of government-sponsored enterprises, U.S. corporate debt securities, equity securities and other financial instruments. Following is a summary of investments classified as available-for-sale, which are carried at fair value as of December 31, 2003:

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
		(in millions)		
U.S. Treasury securities and obligations of government-sponsored enterprises	**$ 217.3**	**$ 1.4**	**$0.7**	**$ 218.0**
Obligations of states and political subdivisions	**6.2**	**0.2**	**–**	**6.4**
Debt securities issued by foreign Governments	**14.0**	**0.1**	**–**	**14.1**
Asset-backed securities	**187.0**	**1.6**	**1.0**	**187.6**
U.S. corporate debt securities	**221.9**	**6.4**	**0.6**	**227.7**
Other debt securities	**92.8**	**1.9**	**2.8**	**91.9**
Total debt securities	**739.2**	**11.6**	**5.1**	**745.7**
Mutual funds	**160.0**	**10.3**	**2.3**	**168.0**
Equity securities	**113.5**	**26.0**	**1.4**	**138.1**
Auction rate securities	**257.5**	**–**	**–**	**257.5**
Total	**$1,270.2**	**$47.9**	**$8.8**	**$1,309.3**

Unrealized gains (losses) from available-for-sale securities recorded in members' equity also include the Company's share of available-for-sale securities unrealized gains (losses) of equity investees.

As of December 31, 2003, all held-to-maturity investments were U.S. Treasury securities and obligations of government-sponsored enterprises. The securities had an amortized cost of $28.3 million and had gross unrealized gains of $54,000. Total estimated fair value of these held-to-maturity investments was $28.3 million at December 31, 2003. All investments classified as held-to-maturity mature in 2004 and 2005 in the amounts of $23.8 million and $4.5 million, respectively.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. INVESTMENTS (continued)

Following is a summary of investments classified as available-for-sale, which are carried at fair value as of December 31, 2002:

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
		(in millions)		
U.S. Treasury securities and obligations of government-sponsored enterprises	$ 254.0	$ 6.1	$ 0.2	$ 259.9
Obligations of states and political subdivisions	12.7	0.1	–	12.8
Debt securities issued by foreign Governments	4.7	0.3	–	5.0
Asset-backed securities	182.3	2.1	0.6	183.8
U.S. corporate debt securities	227.1	8.1	1.5	233.7
Other debt securities	45.5	2.3	3.3	44.5
Total debt securities	726.3	19.0	5.6	739.7
Mutual funds	156.7	1.0	0.7	157.0
Equity securities	159.5	5.9	14.8	150.6
Auction rate securities	183.7	–	–	183.7
Total	$1,226.2	$25.9	$21.1	$1,231.0

As of December 31, 2002, all held-to-maturity investments consisted of U.S. Treasury securities and obligations of government-sponsored enterprises. The cost of the securities were $28.4 million and had gross unrealized capital gains of $577,000 and a total estimated fair value of $29.0 million at December 31, 2003.

Following is a summary, by contractual maturity, of investments classified as available-for-sale as of December 31, 2003:

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
		(in millions)		
Due in one year or less	**$ 218.9**	**$ 0.9**	**$2.5**	**$ 217.3**
Due after one through five years	**210.2**	**3.9**	**1.1**	**213.0**
Due after five through ten years	**75.2**	**2.9**	**0.2**	**77.9**
Due after ten years	**234.9**	**3.9**	**1.3**	**237.5**
Total debt securities	**739.2**	**11.6**	**5.1**	**745.7**
Mutual funds	**160.0**	**10.3**	**2.3**	**168.0**
Equity securities	**113.5**	**26.0**	**1.4**	**138.1**
Auction rate securities	**257.5**	**–**	**–**	**257.5**
Total	**$1,270.2**	**$47.9**	**$8.8**	**$1,309.3**

The gross realized gains on sales in 2003 and 2002 totaled $42.1 million and $23.0 million, respectively, and the gross realized losses totaled $16.7 million and $38.3 million, respectively. Included within gross realized gains (losses) are reclassifications from

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. INVESTMENTS (continued)

unrealized gains (losses) on available-for-sale securities of $4.6 million and ($6.5) million in 2003 and 2002, respectively. These reclassifications represent the recognition of amounts previously recorded as unrealized gain (loss) as of the end of the previous year.

As of December 31, 2003 and 2002, investments with a carrying value of $28.3 million and $28.4 million, respectively, were pledged as collateral for NASDAQ's $25.0 million note payable. Collateral is limited to U.S. Government and agency securities with a margined value of not less than 100% of the loan and is invested in accordance with the note agreement (see Note 8, "Borrowings").

6. GOODWILL AND OTHER INTANGIBLE ASSETS

As of December 31, 2002, the only goodwill recorded by the Company represented goodwill recorded by NASDAQ of $10.2 million related to its acquisitions of NASDAQ Europe and NASDAQ Tools. As of December 31, 2002, $4.1 million of NASDAQ's goodwill was from continuing operations. The $6.1 million of goodwill related to NASDAQ Europe is included in non-current assets discontinued operations in the consolidated balance sheets. As a part of NASDAQ's strategic review in 2003, the goodwill related to these acquisitions was considered impaired and was written down to zero. As of December 31, 2003, NASDAQ did not have any goodwill.

Intangible assets with finite lives continue to be amortized over their estimated useful lives. As of December 31, 2003 and, 2002, the Company has intangible assets of $4.9 million and $5.5 million, respectively. As of December 31, 2003, of the $4.9 million intangible asset balance, $1.2 million was a minimum pension liability, which is not subject to amortization. See Note 10, "Employee Benefits," for further information. The Company estimates amortization expense to be $1.3 million for the years ended December 31, 2004 and 2005, $0.8 million for the year ended December 31, 2006, and $0.3 million for the year ended December 31, 2007.

7. FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company considers cash and cash equivalents, receivables, investments, accounts payable and accrued expenses, due to custodial agent, short and long-term debt, and warrants to purchase NASDAQ stock from NASD to be its financial instruments. The carrying amounts reported in the balance sheets for these financial instruments equal or closely approximate their fair values due to the short-term nature of these assets and liabilities. The approximate fair value of NASDAQ's long-term debt was estimated using a discounted cash flow analysis, based on NASDAQ's assumed incremental borrowing rates for similar types of debt arrangements. This analysis indicates that the fair value of NASDAQ's long-term debt at December 31, 2003 and 2002 approximates its carrying amount.

8. LONG TERM DEBT

NASD CREDIT FACILITY

In September 1999, NASD entered into an unsecured line of credit agreement. Under this agreement, NASD has the option to borrow up to $50.0 million at LIBOR plus 0.3% percent. As of December 31, 2003 and 2002, no amounts were outstanding under this line of credit. The line of credit agreement expires on November 30, 2004.

8. LONG TERM DEBT (continued)

NASDAQ SENIOR NOTES AND CREDIT FACILITY

NASDAQ issued the Senior Notes on May 9, 2002 in a private placement. The Senior Notes were unsecured, paid interest quarterly, and were redeemable by NASDAQ at any time, subject to the make-whole payment. The proceeds from the Senior Notes, approximately $149.0 million after payment of placement agent commissions and expenses of this offering, were used to fund a portion of the cash consideration paid to NASD for the repurchase by NASDAQ of 33.8 million shares of Common Stock owned by NASD and for general corporate purposes. Interest expensed and paid under the agreement totaled approximately $6.5 million and $5.6 million for the years ended December 31, 2003 and 2002, respectively.

On September 30, 2003, NASDAQ redeemed the $150.0 million of its Senior Notes. In conjunction with its strategic review, NASDAQ reassessed its capital needs and determined that it no longer needed the liquidity of the Senior Notes. NASDAQ paid the holders of the Senior Notes $150.0 million in outstanding principal amount, accrued interest of $1.2 million and an aggregate make-whole payment of approximately $12.6 million (representing the net present value of future payments). The repayment amounts reflected the terms of the Senior Notes, except that the parties agreed to a reduced make-whole amount equal to the excess of the discounted value of the remaining scheduled payments discounted at a factor equal to 100 basis points over the yield to maturity of U.S. Treasury securities having a maturity equal to the remaining average life of the redeemed amount. This represented a renegotiation of the 50 basis points over the yield to maturity required by the terms of the Senior Notes. NASDAQ recorded a $13.2 million pre-tax charge in the third quarter of 2003 related to the redemption of the Senior Notes. This charge included the make-whole payment and capitalized costs related to the issuance of the Senior Notes. NASDAQ used funds from available cash and investments to finance the redemption.

On August 29, 2002, NASDAQ entered into an unsecured revolving-credit facility (the “Facility”), which was syndicated to five banks. The Facility made $150.0 million available to NASDAQ for a 364-day term for general corporate purposes at an annual fee of 0.09%. NASDAQ had not utilized this Facility and decided to terminate the Facility effective June 26, 2003.

In May 1997, NASDAQ entered into a $25.0 million note payable with a financial institution (the “Lender”). Principal payments are scheduled to begin in 2007 and continue in equal monthly installments until maturity in 2012. The note requires monthly interest payments through May 2007 at an annual rate of 7.41%. After May 2007, NASDAQ will incur interest equal to the Lenders’ cost of funds rate, as defined in the agreement, plus 0.5%. Interest expensed and paid under the agreement totaled approximately $1.9 million for each of the years ended December 31, 2003 and 2002.

NASDAQ SUBORDINATED NOTES

On May 3, 2001, NASDAQ issued and sold $240.0 million in aggregate principal amount of 4.0% convertible subordinated notes due 2006 (the “Subordinated Notes”) to Hellman & Friedman Capital Partners IV, L.P. and certain of its affiliated limited partnerships (collectively, “Hellman & Friedman”). NASDAQ used the proceeds from the sale of the Subordinated Notes to purchase 18,461,538 shares of common stock from NASD for $13.00 per share. On November 12, 2001, NASDAQ sold an aggregate amount of 500,000 shares of common stock to Hellman & Friedman for an aggregate offering price of $5,125,000, which was the fair value at that date.

Until NASDAQ is granted Exchange Registration, Hellman & Friedman may only exercise its conversion rights for a number of shares of common stock such that immediately following such conversion, NASD will continue to control greater than 50% of the combined voting power of NASDAQ. The annual 4.0% coupon will be payable in arrears and the Subordinated Notes are

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

8. LONG TERM DEBT (continued)

convertible at any time into an aggregate of 12.0 million shares of common stock at $20.00 per share, subject to adjustment, in general, for any stock split, dividend, combination, recapitalization or other similar event. Interest expensed and paid under the agreement totaled approximately $9.6 million for the years ended December 31, 2003 and 2002.

In 2002, NASDAQ stockholders approved an amendment to NASDAQ's Restated Certificate of Incorporation (the "Certificate of Incorporation") that provided for voting debt. As a result, the holders of the Subordinated Notes may vote on an as-converted basis on all matters on which holders of common stock have the right to vote, subject to the current 5.0% voting limitation in the Certificate of Incorporation. NASDAQ has granted Hellman & Friedman certain registration rights with respect to the shares of Common Stock underlying the Subordinated Notes.

On an as-converted basis as of December 31, 2003, Hellman & Friedman owned an approximate 13.8% equity interest in NASDAQ as a result its ownership of these Subordinated Notes and 500,000 shares of Common Stock. Hellman & Friedman is permitted to designate one person reasonably acceptable to NASDAQ for nomination as a director of NASDAQ for so long as Hellman & Friedman owns Subordinated Notes and/or shares of Common Stock issued upon conversion thereof representing at least 50.0% of the shares of Common Stock issuable upon conversion of the Subordinated Notes initially purchased. F. Warren Hellman, chairman of Hellman & Friedman, served as a director of NASDAQ pursuant to this agreement as of December 31, 2003.

NASDAQ's Board of Directors has accepted the resignation of F. Warren Hellman from their Board, effective February 25, 2004. Pursuant to the terms of the security holders agreement, dated as of March 23, 2001, between NASDAQ and Hellman & Friedman, Hellman & Friedman currently is permitted to designate one person reasonably acceptable to NASDAQ for nomination as a director of NASDAQ. Accordingly, Hellman & Friedman designated Patrick Healy to replace Mr. Hellman. NASDAQ's nominating committee subsequently nominated Mr. Healy to the NASDAQ Board and the NASDAQ Board of Directors elected Mr. Healy, effective March 4, 2004.

9. INCOME TAXES

The income tax provision includes the following amounts, which relate to NASDAQ:

	Years ended December 31, 2003	2002
	(in thousands)	
Current income tax (benefit) provision:		
Federal	**$(26,753)**	$21,812
State	**11**	5,204
Foreign	**2,790**	243
Total current income tax (benefit) provision	**(23,952)**	27,259
Deferred income tax (benefit) provision:		
Federal	**7,180**	11,259
State	**(4,468)**	2,403
Total deferred income tax (benefit) provision	**2,712**	13,662
Total (benefit) provision for income taxes	**$(21,240)**	$40,921

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

9. INCOME TAXES (continued)

Reconciliations of the statutory U.S. federal income tax rates to the effective tax rates for the Company's taxable entities are as follows:

	Years ended December 31, 2003	2002
Federal	**35.0%**	35.0%
State	**4.4**	4.7
Foreign losses without U.S. benefit	**(2.2)**	2.4
Tax preferred investments	**1.0**	(0.7)
Tax credits	**2.6**	(2.2)
Goodwill impairment	**(2.2)**	–
Deferred tax asset write-off	**(4.4)**	–
Other, net	**(2.2)**	(0.6)
Effective rate	**32.0%**	38.6%

The following represents the domestic and foreign components of income (loss) before income tax expense for the Company's taxable entities:

	Years ended December 31, 2003	2002
	(in thousands)	
Domestic	**$(75,114)**	$113,715
Foreign	**8,762**	(7,773)
Income before income tax expense and discontinued operations	**$(66,352)**	$105,942

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

9. INCOME TAXES (continued)

Components of the Company's deferred tax assets and liabilities consisted of the following:

	December 31, 2003	December 31, 2002
	(in thousands)	
Deferred tax assets:		
Deferred fees	**$ 56,624**	$ 72,553
Foreign net operating loss	**1,576**	13,718
Net operating loss carryforwards	**34,191**	21,330
State net operating loss	**5,466**	–
Bad debts	**1,307**	9,558
Technology costs	**3,680**	9,598
Compensation and benefits	**8,252**	10,722
Lease reserves	**7,949**	7,810
Deferred capital loss carryforward	**87,755**	25,566
Strategic review charges	**16,326**	–
Other	**13,195**	14,630
Total deferred tax asset	**236,321**	185,485
Deferred tax liabilities:		
Depreciation	**(8,269)**	(10,841)
Investment in Amex LLC	**(37,400)**	(30,162)
Software development costs	**(31,843)**	(35,892)
Other	**(3,198)**	(4,805)
Total deferred tax liabilities	**(80,710)**	(81,700)
Net deferred taxes before valuation allowance	**155,611**	103,785
Valuation allowance	**(86,382)**	(32,304)
Net deferred tax assets	**$ 69,229**	$ 71,481

The change in the valuation allowance from December 31, 2002, to December 31, 2003 is as follows:

	(in thousands)
Balance December 31, 2002	$(32,304)
Utilization of prior year foreign net operating losses in the current Period	1,616
Reduction of prior year foreign net operating loss deferred tax assets due to dissolution of foreign subsidiary	10,785
Net operating loss carryforwards generated in 2003	(12,861)
Foreign net operating loss carryforwards generated in 2003	(259)
Capital loss carryforwards generated in 2003	(55,206)
Other	1,847
Balance December 31, 2003	$(86,382)

9. INCOME TAXES (continued)

Of the \$5.5 million state and the \$1.6 million of foreign net operating losses at December 31, 2003, state losses of \$5.5 million will expire through 2023, foreign losses of \$0.3 million will expire 2007 through 2010 and \$1.3 million have no expiration date.

As of December 31, 2003, the Company had total capital loss carryforwards of \$87.8 million, of which \$80.7 million were generated through discontinued operations. The capital loss carryforwards generated through discontinued operations will expire in 2008. Of the remaining \$7.1 million of capital loss carryforwards, \$1.0 million will expire 2007 through 2008, and \$6.1 million is a deferred capital loss carryforward with no expiration date determined as of year-end.

As of December 31, 2003 and 2002, NASD Holding has net operating loss carryforwards of \$76.0 million and \$47.4 million, respectively. These net operating loss carryforwards begin to expire in 2018. Under SFAS No. 109, to record a deferred tax asset without a valuation allowance, it must be more likely than not that the deferred tax asset will be realized. The Company does not believe the capital loss carryforward and net operating loss carryfoward will be realized. Therefore, a valuation allowance of \$86.4 million and \$32.3 million has been recorded as of December 31, 2003 and 2002, respectively.

10. EMPLOYEE BENEFITS

As of December 31, 2003 and 2002, the Company provided two non-contributory defined benefit pension plans and one non-contributory postretirement benefit plan (Postretirement Plan) for the benefit of eligible employees of its subsidiaries. The non-contributory defined benefit plans consists of a funded ERP and an unfunded SERP. The benefits are primarily based on years of service and the employees' average salary during the highest 60 consecutive months of employment. Beginning on January 1, 2004, the benefits for NASDAQ are primarily based on years of service and the employees' career-average salary during employment, subject to a phase in period. The Postretirement Plan represents a life insurance benefit available to eligible retired employees.

The investment policy and strategy of the plan assets, as established by the NASD Retirement Plan Committee, is to provide for preservation of principal, both in nominal and real terms, in order to meet the long-term spending needs of the Plan by investing assets per the target allocations stated below. Asset allocations are reviewed quarterly and adjusted, as appropriate, to remain within target allocations. The investment policy is reviewed on an annual basis, under the advisement of an investment consultant, to determine if the policy or asset allocation targets should be changed. The plan assets consisted of the following as of December 31:

	Target Allocation	2003	2002
Equity securities	55.0%-75.0%	**74.0%**	67.0%
Debt securities and cash equivalents	25.0%-45.0%	**26.0**	33.0
Total		**100.0%**	100.0%

The expected long-term rate of return for the plan's total assets is based on the expected return of each of the above categories, weighted based on the current target allocation for each class. Equity securities are expected to return 8.0% to 10.0% over the long-term, while debt securities and cash equivalents are expected to return between 4.0% and 6.0%. Based on historical experience, the NASD Retirement Plan Committee expects that the plan's asset managers overall will provide a modest (1.0% per annum) premium to their respective market benchmark indices.

The plan is measured at the beginning of each fiscal year. The Company expects to contribute approximately \$23.6 million to the plans for 2004.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

10. EMPLOYEE BENEFITS (continued)

The following table sets forth the plans' funded status and amounts recognized in the consolidated balance sheets at December 31:

	Pension Benefits	
	2003	**2002**
	(in thousands)	
Change in benefit obligation		
Benefit obligation at beginning of year	**$ 195,734**	$ 159,189
Service cost	**20,906**	17,744
Interest cost	**13,285**	11,830
Amendments	**(3,300)**	1,587
Actuarial losses	**7,626**	12,321
Benefits paid	**(29,162)**	(22,794)
Loss due to change in discount rate	**21,627**	14,870
Other benefits/changes	**–**	987
Benefit obligation at end of year	**$ 226,716**	$ 195,734
Change in plan assets		
Fair value of plan assets at beginning of year	**$ 90,995**	$ 102,247
Transfers between related parties	**–**	960
Actual return on plan assets	**20,425**	(12,708)
Company contributions	**19,158**	23,290
Benefits paid	**(29,162)**	(22,794)
Fair value of plan assets at end of year	**101,416**	90,995
Funded status of the plan (underfunded)	**(125,300)**	(104,739)
Unrecognized net actuarial loss	**73,837**	62,373
Unrecognized prior service cost	**(6,229)**	3,829
Unrecognized transition obligation/(asset)	**(823)**	(1,038)
Amount recognized to reflect minimum liability	**(5,961)**	(4,341)
Net accrued benefit cost	**$ (64,476)**	$ (43,916)

The net accrued pension cost as of December 31, 2003, as reflected above, consists of the accrued benefit cost from the underfunded ERP and the unfunded SERP.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

10. EMPLOYEE BENEFITS (continued)

The components of the accrued benefit cost for the Company's defined benefit pension plans and postretirement benefit plan as of December 31, 2003 and 2002 along with the location of these amounts in the consolidated balance sheets were as follows:

	December 31, 2003	December 31, 2002
	(in thousands)	
Current (included in accrued personnel and benefit costs):		
ERP	**$(18,624)**	$(10,989)
SERP	**(4,926)**	–
Total current	**(23,550)**	(10,989)
Noncurrent (included in accrued pension and other postretirement benefit costs):		
ERP	**(22,828)**	(19,125)
SERP	**(18,098)**	(13,802)
Postretirement Plan	**(381)**	(263)
Total non-current	**(41,307)**	(33,190)
Accrued benefit costs	**$(64,857)**	$(44,179)

As of December 31, 2003 and 2002, the following is the funded status of each of NASD's defined benefit pension plans:

	December 31, 2003	December 31, 2002
	(in thousands)	
ERP		
Projected benefit obligations	**$198,237**	$178,594
Accumulated benefit obligations	**120,110**	100,885
Fair value of plan assets	**101,416**	90,995
SERP		
Projected benefit obligations	**$ 28,479**	$ 17,140
Accumulated benefit obligations	**23,023**	13,742
Fair value of plan assets	**–**	–

During 2003 and 2002, there were settlement losses of $3.9 million and $1.2 million, respectively, for employees included within the SERP due to early retirements.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

10. EMPLOYEE BENEFITS (continued)

Pursuant to the provisions of SFAS No. 87, related to the SERP, an intangible asset of $1.2 million and $1.3 million, and a net (increase) decrease to members' equity of $(0.5) million and $3.1 million, were recorded as of December 31, 2003 and 2002, respectively, to recognize a minimum pension liability. Included within the net adjustment to accumulated other comprehensive income (loss) in the accompanying consolidated balance sheets is the portion of minimum pension liabilities from equity method affiliates.

	Pension Benefits	
	2003	**2002**
Weighted-average assumptions as of December 31:		
Discount rate	**6.25%**	6.75%
Expected return on plan assets	**8.75**	9.0
Rate of compensation increase	**5.5**	5.5

	Pension Benefits	
	2003	**2002**
	(in thousands)	
Components of net periodic benefit cost, years ended December 31:		
Service cost	**$20,906**	$17,744
Interest cost	**13,285**	11,830
Expected return on plan assets	**(7,609)**	(9,025)
Amortization of unrecognized transition asset	**(214)**	(215)
Recognized net actuarial (gains) losses	**2,786**	(57)
Prior service cost (income) recognized	**5,474**	947
Curtailment/settlement loss recognized	**2,964**	3,523
Benefit cost (included in compensation expense)	**$37,592**	$24,747

The Company also maintains voluntary savings plans for eligible employees of its subsidiaries. Employees are immediately eligible to make contributions to the plan and are also eligible for an employer contribution match at an amount equal to 100% of the first 4% of eligible employee contributions. Eligible plan participants may also receive an additional discretionary match from the Company. Savings plan expense for 2003 and 2002 was $11.5 million and $9.0 million, respectively, which is included within compensation expense in the consolidated statements of operations. The expense included a discretionary match totaling $2.4 million for 2003 and $2.1 million for 2002.

11. NASDAQ STOCK COMPENSATION, STOCK AWARDS AND CAPITAL STOCK

Effective December 5, 2000, as amended on January 23, 2002, NASDAQ adopted The Nasdaq Stock Market, Inc. Equity Incentive Plan (the "Plan"), under which nonqualified and qualified incentive stock options, restricted stock, restricted stock units, or other stock based awards may be granted to employees, directors, officers and consultants. A total of 24,500,000 shares are authorized under the Plan. At December 31, 2003, 11,583,676 shares were available for future grants under the Plan.

In 2003, NASDAQ granted 4,398,410 stock options, 14,000 shares of restricted stock to employees and officers and 24,375 shares of restricted stock to non-employee Board of Directors members pursuant to the Plan. NASDAQ also granted 1,000,000 stock options and 100,000 shares of restricted stock outside of the Plan. During 2003, 1,804,289 stock options and 141,900 shares of restricted stock awards were forfeited.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

11. NASDAQ STOCK COMPENSATION, STOCK AWARDS AND CAPITAL STOCK (continued)

In December 2001, NASDAQ's Board adopted a revised Non-Employee Directors Compensation Policy whereby beginning in 2002 all non-employee directors were awarded 5,000 stock options per year with an exercise price at fair market value, which may be exercised for up to 10 years while serving on the Board of Directors (in general, three years from termination of service on the Board of Directors). On January 23, 2002, 65,000 stock options were awarded to all non-employee directors pursuant to the plan. Later in November 2002, the Board approved a modification to the Non-Employee Directors Compensation Policy whereby all non-employee directors will receive a compensation package valued at $40,000. Each non-employee director may elect to receive the compensation package in cash, payable in equal quarterly installments, shares of restricted stock or a combination thereof. The shares of restricted stock will vest two years from the date of grant and unvested shares are forfeited in certain circumstances upon termination of the director's service on the NASDAQ Board. During 2003, 24,375 shares of restricted stock were awarded to non-employee directors.

Restricted stock awards are awarded in the name of the employee or officer at fair value on the date of the grant. The awards contain restrictions on sales and transfers, are generally subject to a five-year vesting period and are expensed over the vesting period. NASDAQ recognized $2.0 million in amortization expense related to restricted stock during the year ended December 31, 2002. For the year ended December 31, 2003, the number of restricted stock awards forfeited more than offset the yearly amortization expense to a $0.05 million benefit.

Stock options are granted with an exercise price equal to the estimated fair market value of the stock on the date of the grant. NASDAQ accounts for stock option grants in accordance with APB No. 25, and, accordingly, recognizes no compensation expense related to such grants.

Options granted generally vest over three years and expire 10 years from the date of grant. All options to date have been granted at fair market value on the date of grant. At December 31, 2003, options for 7,550,589 shares were vested, and exercisable with a weighted-average exercise price of $12.43. At December 31, 2002, options for 5,292,654 shares were vested, and exercisable with a weighted-average exercise price of $12.77.

Stock option activity during the year ended December 31, 2003, is set forth below:

		Price per Share	
	Shares	**Range**	**Weighted Average**
Balance, January 1, 2003	10,917,403	$10.25-$19.70	$12.91
Granted	5,398,410	$ 5.28-$ 9.05	$ 7.41
Exercised	–	$ –	$ –
Forfeited	2,892,679	$ 6.30-$19.70	$12.33
Balance, December 31, 2003	13,423,134	$ 5.28-$19.70	$10.82

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

11. NASDAQ STOCK COMPENSATION, STOCK AWARDS AND CAPITAL STOCK (continued)

Stock option activity during the year ended December 31, 2002 is set forth below:

		Price per Share	
	Shares	**Range**	**Weighted Average**
Balance, January 1, 2002	9,625,587	$10.25-13.00	$12.70
Granted	2,220,279	$13.00-19.70	$13.65
Exercised	8,612	$10.25-13.00	$10.65
Forfeited	919,851	$10.25-13.00	$12.38
Balance, December 31, 2002	10,917,403	$10.25-19.70	$12.91

NASDAQ has an employee stock purchase plan for all eligible employees. Under the plan, shares of Common Stock may be purchased at six-month intervals (each, an "Offering Period") at 85% of the lower of the fair market value on the first or the last day of each Offering Period. Employees may purchase shares having a value not exceeding 10% of their annual compensation, subject to applicable annual IRS limitations. During 2003 and 2002, employees purchased an aggregate of 143,352 and 210,046 shares at a weighted-average price of $6.95 and $10.22 per share, respectively.

Pro forma information regarding net income is required under SFAS No. 148 and has been determined as if NASDAQ had accounted for all stock option grants based on a fair value method. The fair value of each stock option grant was estimated at the date of grant using the Black-Scholes valuation model assuming a weighted-average expected life of five years, weighted-average expected volatility of 30% and a weighted-average risk free interest rate of 2.94% and 4.31% for 2003 and 2002, respectively. The weighted-average fair value of options granted in 2003 and 2002 was $2.37 and $4.69, respectively.

Pro forma income from continuing operations includes the amortization of the fair value of stock options over the vesting period and the difference between the fair value and the purchase price of common shares purchased by employees under the employee stock purchase plan. The pro forma income from continuing operations for the years ended December 31, 2003 and, 2002 is as follows:

	2003	**2002**
Income from continuing operations	**$50,006**	$139,619
Compensation expense	**(7,143)**	(4,384)
Pro forma income from continuing operations	**$42,863**	$135,235

On February 18, 2004, NASDAQ's Board approved a Performance Accelerated Stock Option (PASO) Plan for Management and granted 1,245,000 options. These options are not included in the above calculation.

12. LEASES

The Company leases certain office space and equipment in connection with its operations. The majority of these leases contain escalation clauses based on increases in property taxes and building operating costs. Certain of these leases also contain renewal options. Rent expense for operating leases was $41.4 million in 2003 and $34.9 million in 2002.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

12. LEASES (continued)

Future minimum lease payments under non-cancelable operating leases with initial or remaining terms of one year or more consisted of the following at December 31, 2003:

	(in thousands)
Year ending December 31,	
2004	$ 37,018
2005	34,831
2006	34,130
2007	32,270
2008	29,520
Remaining years	271,508
Total minimum lease payments	$439,277

Future minimum lease payments under non-cancelable capital leases with initial or remaining terms of one year or more consisted of the following at December 31, 2003:

	(in thousands)
Year ending December 31,	
2004	$2,354
2005	809
2006	809
2007	68
Total minimum lease payments	4,040
Less: imputed interest	(66)
Total present value of minimum lease payments	$3,974

13. COMMITMENTS AND CONTINGENCIES

NASD

On June 1, 1999, NASD finalized a 10-year agreement with EDS Corporation (the "EDS Agreement") to establish an alliance, NasTech, through which EDS provides technology services to NASD and NASDR. NASD had an obligation to pay to EDS a minimum of $47.9 million each year under the term of the EDS Agreement except for 2009, which was to be prorated through the ending date of the original EDS Agreement on May 31, 2009. On April 1, 2003, NASD and EDS entered into a new service agreement (2003 EDS Agreement), which supersedes the existing EDS Agreement. The new agreement included several modifications, including a more detailed statement of work, enhanced service levels, improved pricing, and an extended term. The 2003 EDS Agreement expires on December 31, 2012, representing an extension of 3.5 years. Under the 2003 EDS Agreement, NASD is obligated to pay EDS a minimum of $24.0 million for the first year, (prorated for a 9-month period during 2003 commencing on the effective date), which is reduced ratably to $16.0 million in the final year, for both applications development and maintenance services. NASD is also required to use EDS for all their production services needs. Furthermore, NASD cannot terminate the 2003

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

13. COMMITMENTS AND CONTINGENCIES (continued)

EDS Agreement until April 1, 2005, at which point the termination fee is based on a fixed fee schedule versus the formula-based approach in the initial agreement. As consideration for the 2003 EDS Agreement, NASD agreed to forgive the $34.3 million deposit with EDS. This deposit is being amortized on a straight-line basis over the remaining term of the 2003 EDS Agreement. As of December 31, 2003 and 2002, NASD recorded other assets of $32.6 million and $34.3 million, respectively, representing the unamortized balance of the deposit with EDS.

In 2001, NASD entered into a series of incentive agreements with the City of New York resulting in potential incentives aggregating $53.6 million on a net present value basis to NASD, NASDAQ, and Amex. During 2003 and 2002, the Company recognized benefits of $1.1 million for each year in real estate tax abatement and $0.1 million and $0.3 million, respectively, in sales tax abatement under this agreement.

In April 2003, NASD received $3.0 million of a capital grant from the New York State Urban Development Corporation d/b/a Empire State Development Corporation (ESDC). The terms of this grant require NASD to maintain a set number of full-time employees within New York City annually until January 1, 2009. If NASD does not meet the required headcount as summarized in this grant, NASD will be required to pay back to ESDC either all or a portion of the grant received. As of December 31, 2003, the Company has met the headcount requirements as stipulated in the agreement. In accordance with the terms of this agreement, the Company has recorded the $3.0 million capital grant in other liabilities in the consolidated balance sheet.

NASDAQ

NASDAQ entered into a six-year $600.0 million contract with MCI in 1997 to replace the data network that connected the NASDAQ market facilities to market participants. As part of that contract, NASDAQ provided a guaranteed revenue commitment to MCI of $300.0 million. Under the terms of this contract, NASDAQ was permitted to renegotiate the contract once the minimum guarantee was satisfied. In June 2002, an amendment to the original contract was negotiated with MCI once the minimum usage level of $300.0 million was achieved from the original contract. The amended contract supersedes the terms of the existing contract and is for $182.0 million over three years commencing in June 2002. The three-year contract includes fixed and variable cost components for two years and permits NASDAQ to terminate the contract in certain circumstances after the second year. On January 30, 2004, NASDAQ and MCI entered into a new global service agreement (GSA) terminating the current agreement effective May 31, 2004. The GSA, which expires on December 31, 2005, requires usage charges for certain GSA services to be at least $20.0 million during the period from June 1, 2004 to December 31, 2004, and $20.0 million in 2005.

On June 1, 2001, NASDAQ signed an agreement with LIFFE creating NQLX, a U.S. joint venture company to list and trade single stock futures. On November 8, 2002, NASDAQ launched NQLX. The NASDAQ Board approved a capital contribution of $25.0 million to the NQLX joint venture. During 2002 and 2001, NASDAQ made $2.0 million and $16.0 million, respectively, of capital contributions to the NQLX joint venture. As of June 30, 2003, $23.0 million had been contributed, and NASDAQ also agreed to redeem its interest in the NQLX joint venture. On July 17, 2003, NASDAQ fulfilled its remaining funding obligation by contributing $2.0 million to NQLX, with the aggregate contributions totaling $25.0 million. On July 24, 2003, NASDAQ, LIFFE and NQLX executed a Redemption and Separation Agreement, at which time NASDAQ ceased to be a partner of NQLX for state law purposes and ceased to share in partnership profits. See Note 3, “Significant Transactions.”

NASDAQ accounted for its investment in NQLX under the equity method of accounting. In 2003 and 2002, NASDAQ recorded losses of $4.1 million and $9.0 million, respectively, representing its share of losses incurred by NQLX.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

13. COMMITMENTS AND CONTINGENCIES (continued)

The Company may be subject to claims arising out of the conduct of its business. Currently, there are certain legal proceedings pending against the Company. Management believes, based upon the opinion of counsel, it has adequately provided for any liabilities or settlements arising from these proceedings. Management is not aware of any unasserted claims or assessments that would have a material adverse effect on the financial position and the results of operations of the Company.

14. REAL ESTATE DEVELOPMENTS

NASD

In December 2003, NASD decided to vacate office space in Rockville, Maryland. NASD was obligated under this lease agreement to pay $5.0 million over the life of the lease, which expires in July 2006. As of December 31, 2003, the estimated loss on the sublease was $3.6 million, which has been included within occupancy expense in the consolidated statements of income. This estimated loss was calculated using NASD's incremental borrowing rate of 1.75%, and an estimated 2-year sublease, commencing in 2004 at estimated market rates.

NASDAQ

In 2002, NASDAQ signed a lease agreement for 1500 Broadway, located directly across from its Times Square MarketSite building in response to a decision to relocate its New York City Headquarters from One Liberty Plaza. Subsequently, NASDAQ decided to maintain its headquarters at One Liberty Plaza. As of December 31, 2002, NASDAQ was obligated under the terms of its 1500 Broadway lease to pay $84.5 million over the life of the lease and as of December 31, 2002 recorded an estimated loss on the sublease (including interest accretion) of $23.2 million, including leasehold improvements. NASDAQ updated this loss estimate, as of December 31, 2003, based on current assumptions and determined the original estimate was still considered proper. At December 31, 2003, the estimated loss on the sublease was approximately $20.5 million. The estimated loss was adjusted throughout the year to reflect interest accretion and rental payments made during 2003. The estimated loss was calculated using NASDAQ's incremental borrowing rate of 7.5%, and an estimated 21-year sublease term commencing in 2004 at estimated market rates.

During 2003, NASDAQ decided to vacate part of the space it occupies in Rockville, Maryland at 9600 Blackwell. As of December 31, 2003, NASDAQ was obligated under the terms of this lease to pay $7.7 million over the remaining life of the lease and recorded an estimated loss on the sublease of $2.3 million, which was included in other expenses on the consolidated statements of income. Also, as a part of the strategic review, NASDAQ vacated the space NASDAQ Tools occupied at 15 Exchange Place, in Jersey City, New Jersey. As of December 31, 2003 NASDAQ was obligated under the terms of this lease to pay $2.8 million over the remaining life of the lease and recorded an estimated loss on the sublease of $1.2 million, which was included in the elimination of non-core product lines, initiatives and severance on the consolidated statements of income. Both estimated losses were calculated using a 7.5% net discount rate and estimated 8-year and 7-year sublease terms for 9600 Blackwell and 15 Exchange Place, respectively and, commencing in the later part of 2004 at estimated market rates.

As of December 31, 2003, management believes the sublease reserve balance for the above properties is adequate. All space is currently being marketed for sublease.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

15. DISCONTINUED OPERATIONS

Amex

In connection with NASD's overall corporate restructuring, NASD and Amex's Boards agreed that it was appropriate to begin the process of separating Amex from NASD. During 2002, NASD engaged an investment banker to assist with the various alternatives related to the separation of Amex. On May 30, 2003, NASD agreed in principle to sell its interest in Amex to a private equity firm. Subsequently, this firm informed NASD that it no longer wished to pursue negotiations related to the sale of NASD's interest in Amex. On October 31, 2003, NASD agreed in principle to sell its Class B Interest of Amex, which is held by NASD Holding, to Amex Membership Corporation. In February 2004, NASD and Amex Membership Corporation signed a definitive sale agreement pursuant to which Amex Membership Corporation will acquire from NASD the Class B Interest in Amex. On February 26, 2004, NASD's Board of Governors approved the transaction. On March 18, 2004, the members of Amex Membership Corporation voted at a Special Meeting to approve the transaction. On March 31, 2004, the Amex Board of Governors approved the transaction.

As of December 31, 2003, NASD's investment in the Class B Interest of Amex met the criteria under SFAS No. 144 to be reported as a discontinued operation. Management believes that the sale of Amex will be completed within one year and that it is unlikely that significant changes will be made to the plan to sell. The transaction is pending SEC approval.

As of December 31, 2003 and 2002, the assets and liabilities of Amex, comprising of the disposal group, are segregated on the consolidated balance sheets and the net operations of Amex have been reported within discontinued operations on the consolidated statements of income. Amex was previously reported by NASD as a separate segment under the provisions of SFAS No. 131. Revenues for Amex for the years ended December 31, 2003 and 2002, were $235.7 million and $252.5 million, respectively.

The following table presents the combined carrying amounts of the major classes of assets and liabilities of Amex:

	December 31, 2003	December 31, 2002
	(in millions)	
Current assets:		
Cash and cash equivalents	**$ 23.6**	$ 25.9
Available-for-sale investments	**45.1**	35.7
Receivables, net	**45.2**	57.4
Other current assets	**6.6**	4.6
Total current assets of discontinued operations	**120.5**	123.6
Total non-current assets of discontinued operations	**32.8**	65.4
Total assets of discontinued operations	**153.3**	189.0
Current liabilities:		
Accounts payable and accrued expenses	**26.4**	31.0
Other current liabilities	**76.5**	68.5
Total current liabilities of discontinued operations	**102.9**	99.5
Accrued pension and other postretirement benefits	**30.9**	28.5
Other liabilities	**10.4**	27.2
Total non-current liabilities of discontinued operations	**41.3**	55.7
Total liabilities of discontinued operations	**$144.2**	$155.2

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

15. DISCONTINUED OPERATIONS (continued)

For the years ended December 31, 2003 and 2002, NASD recorded a loss from discontinued operations related to Amex of $47.4 million and $121.2 million, respectively. Included in the loss from discontinued operations is an estimated loss at disposal recorded as of December 31, 2003 and 2002, of $83.3 million and $134.6 million, respectively, representing the adjustment of the carrying value of Amex long-lived assets to estimated fair value and certain costs expected to be funded by NASD, which are probable of payment as of year end. These costs, which were $39.3 million and $37.9 million as of December 31, 2003 and 2002, respectively, cover: i) employee severance costs and retirement benefits owed to certain Amex executives that are due upon change of control, ii) the cost of settling a specific legal claim, iii) certain lease payments, and iv) professional costs associated with the sale transaction (investment banker, legal, accounting, etc.).

The following contracts, commitments, and contingencies exist with respect to Amex.

The transaction agreement entered into by NASD related to the acquisition of Amex included a Member Equity Program (the "Program") to support the value of Amex members' seats. On October 30, 1998, the closing date of NASD's acquisition of Amex, NASD committed $30.0 million to support seat prices with an additional $10.0 million commitment effective on January 1, 1999. This fund can grow through a 5.0% return on the account, which is offset by seat purchases made by NASD.

In June 2000, the Seat Committee recommended, and the Amex members approved, a disbursement of $15.0 million to the Amex membership. In 2003, the Seat Committee recommended, and on December 10, 2003, the Amex members approved, a disbursement of $15.0 million, adjusted for seat purchases made to date by NASD of $3.6 million, to the Amex membership. Subsequent to the 2003 approval, NASD purchased 6 seats for a total of $520,000. As of December 31, 2003, $20.9 million remains outstanding under this commitment plus accrued interest of $7.6 million. As of December 31, 2003, NASD accrued for their remaining obligation under this agreement, which is included within loss from discontinued operations in the consolidated financial statements. In January 2004, NASD made a payment of $11.4 million to the members, resulting in a remaining obligation of $17.1 million. This amount consists of $9.5 million from the initial obligation plus the aforementioned accrued interest of $7.6 million.

As a condition of NASD's acquisition of Amex, a Member Supplement Fund was established under which annual distributions may be made by NASD based upon 15.0% of the amount, if any, that the net income of Amex exceeds established thresholds for the years 1999 through 2008. Funds will be distributed to owners of membership interests in Amex or used to pay for investments in technology as determined by a Member Supplement Fund Committee. No payments were required to be made for 2003 and 2002 under the Member Supplement Fund formula.

At December 31, 2003, the rights to trade on Amex were embodied through the American Stock Exchange, Inc. (Amex Corp) in the 864 memberships (the "Amex Members"). In accordance with the Limited Liability Company Agreement of Amex, in the event of liquidation of Amex, Amex Corp. will satisfy all obligations of the company and distribute any remaining cash as follows: (1) each existing regular Amex member shall receive an equal distribution up to $26,000; (2) each Amex options principal member shall then receive an equal distribution up to $15,000; (3) the remainder shall then be distributed in a manner such that each regular Amex member will receive from such remaining assets two times the amount distributed to each Amex options principal member. The total amount to be distributed to the Amex members is capped at $140.0 million.

In September 2000, Amex entered into a stipulation with the Department of Justice pursuant to which a decree was entered and an offer of settlement pursuant to which the SEC entered an order which, together, resolved investigations into options listing activity at Amex and other exchanges. Contemporaneous to these investigations, class action lawsuits were filed against Amex, other exchanges, and others. Amex entered into an agreement to settle these class action lawsuits in August 2000, with one-third of the total agreed upon settlement amount paid in August 2000, one-third paid in June 2001, and the remaining one-third to be paid in July 2002. Amex accrued for the remaining settlement payments in 2000 with the signing of the settlement agreement.

15. DISCONTINUED OPERATIONS (continued)

The exact amount of Amex's settlement is confidential. The settlement is subject to the approval of the court, which declined to grant such approval for jurisdictional reasons in April 2001. On January 9, 2003, the Second Circuit affirmed the dismissal of the consolidated complaint, but vacated the district court's refusal to entertain a motion for preliminary approval of the settlement and remanded the matter to the district court for consideration of such a motion. On February 11, 2004, plaintiffs filed a motion for preliminary approval of the settlement. The district court has not yet ruled on that motion.

The Office of Compliance Inspections and Examinations (OCIE) conducted and completed their inspection of Amex's regulatory programs related to customer options order handling. On June 16, 2003, OCIE issued its report and referred their findings related to this inspection to the SEC's Division of Enforcement. The Company is actively working with SEC staff on this matter, including preliminary discussions to arrive at a settlement. At this time the Company cannot predict the outcome of the Division of Enforcement's investigation and whether such outcome will have a material financial statement impact.

SIAC, an affiliated company of Amex, has a lease agreement for a data processing site. The NYSE, as majority owner of SIAC, has guaranteed SIAC's performance under the terms of the lease, which has a remaining obligation of $157.4 million over the next eight years. Amex has agreed to indemnify the NYSE for a portion of losses, if any, sustained by the NYSE in the event of a default by SIAC. The Amex's share of potential losses ($37.8 million, or 24%, at December 31, 2003) is based upon its utilization of SIAC services for the preceding three years, and is adjusted annually. Amex has not made any payments under this indemnification agreement to date and no amounts are reflected in the accompanying financial statements for this guarantee.

In October 2002, Amex received a $3.0 million grant from the ESDC. The terms of this grant require Amex to maintain a set number of full-time employees within New York City annually until January 1, 2012. If Amex does not meet the required headcount as summarized in this grant, Amex will be required to pay back to ESDC a portion of the grant received. Further, if Amex were to relocate employees outside of New York City, they may be required to pay back the full amount of the grant plus additional penalties associated with such relocation, depending on when such relocation occurred. No accrual has been recorded for relocation related penalties, since management believes the risk of such relocation is remote.

On April 30, 2004, NASD & Amex signed a regulatory service agreement, pursuant to which NASD will provide certain regulatory services and develop certain regulatory technologies for Amex. If Amex requires additional services or technologies, beyond the initially agreed scope of work, Amex generally is required to give NASD the opportunity to perform such additional services. Further, NASD may extend financing to Amex for the costs of technology and related matters that may be required to be implemented by the SEC, but NASD will not extend financing for any fines or penalties imposed on Amex by the SEC as a result of its ongoing investigation.

NASDAQ EUROPE AND INDIGOMARKETS

As a result of the strategic review, NASDAQ supported the closing of the market operated by NASDAQ Europe, in which NASDAQ owned a 63.0% interest through December 18, 2003. At an Extraordinary General Meeting held on June 26, 2003, the shareholders of NASDAQ Europe voted to discontinue operations of the market, and, as a result, market operations were wound-down pursuant to a Transition Plan approved by the Belgian Banking and Finance Commission. As NASDAQ Europe was winding-down its market operations, NASDAQ reached an agreement to transfer all of NASDAQ's shares in NASDAQ Europe to one of that company's original investors; the cash consideration for the transaction was nominal. The transfer of NASDAQ's shares of NASDAQ Europe was completed on December 18, 2003. The entity ceased using the NASDAQ Europe name after the transaction. As part of the transaction, NASDAQ Europe's new owner committed to seek to restructure that company's obligations and, in that context,

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

15. DISCONTINUED OPERATIONS (continued)

to request from certain major creditors releases of any claims they might have against NASDAQ Europe's former directors, officers and shareholders (if such claims are related to NASDAQ's prior ownership interest in NASDAQ Europe). At the time of the transfer, NASDAQ Europe had approximately $12.0 million of external debt and accrued interest. NASDAQ has recorded liabilities that management believes are sufficient to satisfy any potential claims against NASDAQ.

Also, as part of NASDAQ's strategic review, during the third quarter of 2003, NASDAQ supported NASDAQ Europe's position in favor of the decision of the shareholders of NASDAQ Deutschland AG (NASDAQ Deutschland), a German exchange in which NASDAQ Europe had a 50.0% interest, to suspend that company's trading operations effective August 29, 2003. NASDAQ Europe transferred all of its shares in NASDAQ Deutschland to one of the other shareholders, BWB Holding AG, as of August 29, 2003.

The charge related to the orderly wind-down and liquidation of market operations in Belgium and Germany was approximately $48.2 million (excluding the minority interest benefit of $2.0 million) for the year ended December 31, 2003. The $48.2 million charge includes the $29.4 million impairment of certain technology platforms held for sale and owned by NASDAQ Europe, the impairment of goodwill of $8.1 million (NASDAQ Europe and NASDAQ Deutschland), severance costs of $2.5 million, and other costs of $8.2 million including contract cancellations.

On September 30, 2003, NASDAQ Global sold its interest in IndigoMarkets to its partner SSI and recognized a gain of approximately $0.6 million on the sale. In addition, on December 18, 2003, NASDAQ transferred its interest in NASDAQ Europe to one of that company's original investors for nominal cash consideration.

In accordance with SFAS No. 144, both NASDAQ Europe and IndigoMarkets are reflected as discontinued operations for all periods presented. As of December 31, 2003 and 2002, the assets and liabilities of NASDAQ Europe and IndigoMarkets are segregated on the consolidated balance sheets and the net operations of NASDAQ Europe and IndigoMarkets have been reported within discontinued operations on the consolidated statements of income. NASD previously reported both NASDAQ Europe and IndigoMarkets under the NASDAQ segment in accordance with the provisions of SFAS No. 131. Combined revenues for NASDAQ Europe and IndigoMarkets for the years ended December 31, 2003 and 2002, were $10.6 million and $11.6 million, respectively. NASDAQ Europe and IndigoMarkets had combined net losses for the years ended December 31, 2003 and 2002, of $60.3 million and $21.9 million, respectively.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

15. DISCONTINUED OPERATIONS (continued)

The following table presents the combined carrying amounts of the major classes of assets and liabilities of NASDAQ Europe and IndigoMarkets:

	December 31, 2003	December 31, 2002
	(in millions)	
Current assets:		
Cash and cash equivalents	$–	$ 2.8
Receivables, net	–	9.0
Other current assets	–	2.8
Total current assets of discontinued operations	–	14.6
Net property and equipment	–	32.5
Goodwill	–	6.1
Other assets	–	8.2
Total non-current assets of discontinued operations	–	46.8
Total assets of discontinued operations	$–	$61.4
Current liabilities:		
Accounts payable and accrued expenses	$–	$18.0
Current portion of senior notes	–	11.3
Other liabilities	–	2.3
Total current liabilities of discontinued operations	–	31.6
Long-term debt	–	14.7
Other liabilities	–	1.8
Total non-current liabilities of discontinued operations	–	16.5
Total liabilities of discontinued operations	–	48.1
Minority interests of discontinued operations	$–	$ (6.5)

The following contracts, commitments and contingencies exist with respect to NASDAQ Europe.

NASDAQ Europe had $26.0 million of notes payable outstanding with third parties as of December 31, 2002. These notes were denominated in Euros. NASDAQ Europe incurred interest expense at a rate of 6.0% on approximately $4.3 million of the notes and LIBOR plus 1.0% on the remaining $21.7 million. In October 2002, NASDAQ Europe's strategic investors committed to convert the majority of NASDAQ Europe's external debt to equity. The conversion was formally approved by NASDAQ Europe's Board of Directors in March 2003. On May 26, 2003, the strategic investors converted approximately $17.9 million, or 63.3%, of NASDAQ Europe's external debt to equity ($51.5 million, or 83.2%, including intercompany debt with NASDAQ).

As of June 30, 2003, €31.8 million ($36.6 million) was funded in the form of a loan fulfilling a commitment to NASDAQ Europe. Of the funded amount, €14.4 million ($16.6 million) was used to finance the operations of NASDAQ Europe through 2002. During the first and second quarters of 2003, an additional €11.6 million ($13.3 million) was funded for 2003 operations. The remaining

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

15. DISCONTINUED OPERATIONS (continued)

€5.8 million ($6.7 million) was used to enable NASDAQ Europe to invest in NASDAQ Deutschland, a venture among NASDAQ Europe, several German banks and two regional German exchanges.

On June 24, 2003, NASDAQ's Board of Directors approved up to $13.0 million additional commitment in the form of a subordinated loan for the wind-down of market operations of NASDAQ Europe, which was to be conducted pursuant to a transition plan approved by the Belgian Banking and Finance Commission. The funding enabled NASDAQ Europe to conduct an orderly transition of listed issuers, as required under Belgian law, renew certain essential contracts during the wind-down period, satisfy certain severance obligations and operate the NASDAQ Deutschland platform until the closure of the NASDAQ Deutschland market on August 29, 2003. As of December 18, 2003, the entire commitment was funded to NASDAQ Europe and to its wholly-owned subsidiary NASDAQ Europe Limited.

As NASDAQ Europe was winding down its market operations, NASDAQ reached an agreement to transfer all of NASDAQ's shares in NASDAQ Europe to one of that company's original investors; the cash consideration for the transfer was nominal. The transfer of NASDAQ's shares in NASDAQ Europe was completed on December 18, 2003. At the time of this transfer, NASDAQ Europe had approximately $12.0 million of external debt and accrued interest. As a result of the transfer of NASDAQ's shares of NASDAQ Europe, NASDAQ Europe's new owner committed to seek to restructure that company's obligations and, in that context, to request from certain major creditors releases of any claims they might have against NASDAQ Europe's former directors, officers and shareholders (if such claims are related to NASDAQ's prior ownership interest in NASDAQ Europe). At the time of the transfer, NASDAQ Europe had approximately $12.0 million of external debt and accrued interest. NASDAQ has recorded liabilities that management believes are sufficient to satisfy any potential claims against NASDAQ.

16. BUSINESS SEGMENT INFORMATION

As described in Note 2, "Summary of Significant Accounting Policies," NASD manages two primary business segments, NASD and NASDAQ. NASD includes NASD, NASDR, and NASD DR. NASDAQ represents a separate identifiable organization. Transactions between segments are accounted for at fair value as if the transactions were to third parties. All inter-segment transactions have been eliminated in consolidation.

SEGMENT INCOME OR LOSS

NASD's accounting policies for segments are the same as those described in Note 2, "Summary of Significant Accounting Policies." Management evaluates segment performance based on net operating income (loss). Consolidating adjustments include the discontinued operations related to Amex and the elimination of intercompany transactions.

	2003			
	NASD	**NASDAQ**	**Consolidating Adjustments**	**Consolidated**
Revenues, principally from external customers	**$ 505,297**	**$589,845**	**$(67,640)**	**$1,027,502**
Total operating expenses	**518,208**	**647,159**	**(58,470)**	**1,106,897**
Net operating income (loss)	**(12,911)**	**(57,314)**	**(9,170)**	**(79,395)**
Total assets	**1,661,020**	**851,254**	**56,749**	**2,569,023**
Long-lived assets	**155,207**	**242,943**	**–**	**398,150**
Depreciation and amortization	**44,432**	**89,983**	**–**	**134,415**

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

16. BUSINESS SEGMENT INFORMATION (continued)

	2002			
	NASD	**NASDAQ**	**Consolidating Adjustments**	**Consolidated**
Revenues, principally from external customers	$ 518,634	$ 787,154	$(80,506)	$1,225,282
Total operating expenses	502,799	675,307	(74,413)	1,103,693
Net operating income (loss)	15,835	111,847	(6,093)	121,589
Total assets	1,635,586	1,175,914	(31,611)	2,779,889
Long-lived assets	177,513	328,690	–	506,203
Depreciation and amortization	54,726	88,502	(60)	143,168

Summarized below are the significant inter-segment transactions among NASD, NASDAQ, and Amex.

SURVEILLANCE AND OTHER REGULATORY SERVICES

NASDR incurs costs associated with monitoring, legal, and enforcement activities related to the regulation of NASDAQ. These costs are charged to NASDAQ based upon NASD management's estimated percentage of costs incurred by each NASDR department that are attributable directly to The Nasdaq Stock Market surveillance. Inter-segment charges between NASDR and NASDAQ for surveillance and other regulatory services were $61.9 million and $76.7 million for the years ended December 31, 2003 and 2002, respectively.

On June 28, 2000, NASDAQ and NASDR signed a Regulatory Services Agreement to which NASDR or its subsidiaries would provide services to NASDAQ and its subsidiaries commencing upon the effectiveness of Exchange Registration. Pursuant to the terms of the Regulatory Services Agreement, the services provided will be the same type and scope as are currently provided by NASDR to NASDAQ for a term of 10 years. Each regulatory service is to be provided for a minimum of five years, after which time the parties may determine to terminate the provision by NASDR of a particular service. The termination of a particular service will generally be based upon a review of pricing and the need for such service.

ADMINISTRATIVE AND TECHNOLOGY SUPPORT SERVICES

NASD provides certain administrative, corporate and infrastructure services to NASDAQ and Amex. NASD charges these expenses and other operating costs to NASDAQ and Amex based on allocation of direct costs incurred by NASD. Support services provided to NASDAQ and Amex were $1.2 million and $7.3 million for the year ended December 31, 2003, and $5.1 million and $21.2 million for the year ended December 31, 2002, respectively.

In January 2002, NASD and NASDAQ entered into a Separation and Common Services Agreement (New Separation Agreement), which replaced an interim Separation and Common Services Agreement (Interim Separation Agreement). The services to be provided to NASDAQ by NASD under the New Separation Agreement are limited to certain finance, technology infrastructure, facilities sharing and legal services. Under the New Separation Agreement, NASDAQ pays NASD the costs of the services provided, including incidental expenses associated with such services.

NASDAQ provides development, maintenance and support related services to Amex for two NASDAQ systems currently in use by Amex. The agreement for these services expired on February 6, 2004, which coincided with the full reintegration of these systems to Amex. Support services provided to Amex from NASDAQ were $1.5 million and $6.9 million for the years ended December 31, 2003 and 2002, respectively.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

16. BUSINESS SEGMENT INFORMATION (continued)

NASD, NASDAQ, AND AMEX MASTER AGREEMENT

On February 6, 2002, NASD, NASDAQ, and Amex (the "Parties") entered into a Master Agreement that would establish provisions for the ongoing relationships of the Parties. The parties submitted the Master Agreement to the SEC and Department of Justice for review prior to final agreement and execution. Summarized below are some of the significant provisions contained in the Master Agreement.

NASD and NASDAQ agreed to fund a portion of the necessary expenses related to the separation of software, hardware, and data under a plan to transition technology applications and support from NASD and NASDAQ to Amex. NASD originally integrated NASDAQ and Amex technology subsequent to the acquisition of Amex by NASD in October 1998. The total estimated cost of the separation has been set at a maximum of $29.0 million, and is to be shared evenly between NASDAQ and NASD.

As of December 31, 2003, Amex and NASDAQ incurred $28.6 million and $0.4 million, respectively, under this agreement representing the total $29.0 million of costs shared between NASDAQ and NASD. Amex was reimbursed $13.6 million and $7.4 million, in the form of a capital contribution, during the years ended December 31, 2003 and 2002, respectively. As of April 30, 2004, NASD and NASDAQ funded this commitment up to its $29.0 maximum, at the cost of $14.5 million each.

As consideration for certain benefits that NASDAQ agreed to provide to Amex, the Parties agreed that (1) NASDAQ is entitled to realize the $15.1 million of tax loss carryforwards related to the assignment by Market Group of its interest in Amex to New NASD Holding, Inc. and (2) NASD is required to repay NASDAQ $5.6 million in cash relating to NASDAQ's use of federal tax losses allocated by Amex to Market Group for the period beginning November 1, 1998, and ending on June 30, 2000. NASD paid NASDAQ $5.6 million on February 20, 2002. NASDAQ treated the payment as a contribution and reflected it in additional paid-in capital on its consolidated balance sheet. Pursuant to this transaction, NASD recognized a net reduction in equity of $2.5 million related to the minority partner's share of this contribution to NASDAQ.

AMEX'S LINE OF CREDIT WITH NASD

In June 2002, Amex received a $50.0 million revolving line of credit from NASD. Interest on this line of credit is LIBOR plus 0.45%. This line of credit agreement matures on April 30, 2004. In connection with the current transaction to sell Amex to Amex Membership Corporation, NASD has agreed to extend the maturity date on this line of credit to be either October 31, 2011, if the SEC approves the transaction to sell Amex to Amex Membership Corporation, or immediately upon notification from the SEC that they have not approved the transaction. As of December 31, 2003 and 2002 the outstanding balance under this line of credit was $50.0 million. The weighted average interest rate was 1.57% and 1.89% as of December 31, 2003 and 2002, respectively. Interest paid to NASD under this line of credit was $0.8 million for both the years ended December 31, 2003 and 2002.

NASDAQ INSURANCE AGENCY, LLC

In December 2002, NASD entered into an agreement with NASDAQ to sell its 50.0% interest in the NASD Insurance Agency, LLC (subsequently renamed the NASDAQ Insurance Agency, LLC (NIA)) for an initial payment of $0.5 million and up to $5.1 million based on NIA's stream of contingent cash flow through 2011. Under the provisions of the agreement, NASDAQ will pay (a) 20% of NIA's cash flows until NASDAQ has paid NASD $2.3 million from cash flows; (b) 10% of NIA's cash flows until NASDAQ has paid NASD a cumulative amount of $3.0 million from cash flows; (c) 5% of NIA's cash flows until the earlier to occur of NASDAQ paying NASD the full cumulative amount of $5.1 million from cash flows or December 31, 2011. As of December 31, 2003, NASDAQ recorded a $0.1 million dividend payable to NASD for the NIA's 2003 cash flows. For the year ended December 31, 2002, NASDAQ paid NASD $0.5 million related to this agreement.

2003 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

17. SUBSEQUENT EVENTS

On January 30, 2004, NASDAQ and MCI entered into a new GSA terminating the current agreement effective May 31, 2004. The GSA, which expires on December 31, 2005, requires usage charges for certain GSA services to be at least $20.0 million during the period from June 1, 2004 to December 31, 2004 and $20.0 million in 2005.

On February 18, 2004, NASDAQ's Board approved a PASO Plan for Management and granted 1,245,000 options.

In February 2004, NASD and Amex Membership Corporation signed a definitive sale agreement pursuant to which Amex Membership Corporation will acquire from NASD the Class B Interest in Amex. On February 26, 2004, NASD's Board of Governors approved the transaction. On March 18, 2004, the members of Amex Membership Corporation voted at a Special Meeting to approve the transaction. On March 31, 2004, the Amex Board of Governors approved the transaction.

NASDAQ's Board of Directors has accepted the resignation of F. Warren Hellman from their Board, effective February 25, 2004. Pursuant to the terms of the security holders agreement, dated as of March 23, 2001, between NASDAQ and Hellman & Friedman, Hellman & Friedman currently is permitted to designate one person reasonably acceptable to NASDAQ for nomination as a director of NASDAQ. Accordingly, Hellman & Friedman designated Patrick Healy to replace Mr. Hellman. NASDAQ's nominating committee subsequently nominated Mr. Healy to the NASDAQ Board and the NASDAQ Board of Directors elected Mr. Healy, effective March 4, 2004.

In February 2004, 15 firms were censured by NASDR and directed to pay $11.2 million to NASDR in monetary sanctions for failure to deliver mutual fund breakpoint discounts during 2001 and 2002 (a subset of those firms were also sanctioned by the SEC). In March 2004, NASDR censured an investment banking firm and directed it to pay $10.0 million to NASDR in monetary sanctions for improperly extending credit to customers in violation of federal securities laws. In May 2004, NASD censured three major investment banks and directed them to pay $15.0 million for engaging in improper IPO allocation practices.

On April 30, 2004, NASD & Amex signed a regulatory service agreement, pursuant to which NASD will provide certain regulatory services and develop certain regulatory technologies for Amex. If Amex requires additional services or technologies, beyond the initially agreed scope of work, Amex generally is required to give NASD the opportunity to perform such additional services. Further, NASD may extend financing to Amex for the costs of technology and related matters that may be required to be implemented by the SEC, but NASD will not extend financing for any fines or penalties imposed on Amex by the SEC as a result of its ongoing investigation.

On May 25, 2004, NASDAQ entered into a definitive agreement to acquire Brut LLC, the owner and operator of the Brut ECN, for a total consideration of $190.0 million in cash, from SunGard Data Systems Inc. The board of directors of each company has approved the transaction, which is expected to close during the third quarter of 2004, subject to closing conditions and regulatory approval.

On June 16, 2004, Amex received a Civil Investigative Demand in connection with an investigation by the U.S. Department of Justice's (DOJ) Antitrust Division "to determine whether there is, has been, or may be a violation of Section 1 of the Sherman Act, 15 U.S.C. § 1, by conduct, activities or proposed action of the following nature: product allocation agreement between the Amex and the Chicago Board of Options Exchange (CBOE)." Amex is currently working out a schedule with the DOJ for complying with these requests. While Amex believes that no product allocation agreement between Amex and CBOE has ever existed and that the subject of the investigation is without foundation, at this very early stage of the proceedings, Amex is unable to predict the outcome of the DOJ's investigation or whether such outcome will have a material financial statement impact.

NASD BOARDS AND COMMITTEES

NASD BOARD OF GOVERNORS AS OF MAY 1, 2004

Robert R. Glauber (Staff)
Chairman
NASD
Washington, DC

William C. Alsover, Jr. (Industry)
Centennial Securities Company, Inc.
Grand Rapids, MI

John W. Bachmann (Industry)
Edward Jones & Company
St. Louis, MO

M. LaRae Bakerink (Industry)
Westfield Bakerink Brozak, LLC
San Diego, CA

Anthony J. Boglioli (Industry)
Whitehall Brokerage Services, Ltd.
New York, NY

Charles A. Bowsher (Public)
Former Comptroller General of the United States
Bethesda, MD

John J. Brennan (Non-Industry)
The Vanguard Group
Malvern, PA

Richard F. Brueckner (Industry)
Pershing LLC
Jersey City, NJ

James E. Burton (Public)
World Gold Council
London, England

Sir Brian Corby (Public)
Retired, Prudential Assurance Company
Albury Ware, England

David A. DeMuro (Industry)
Lehman Brothers, Inc.
New York, NY

Kenneth M. Duberstein (Public)
The Duberstein Group, Inc.
Washington, DC

Eugene M. Isenberg (Non-Industry)
Nabors Industries, Inc.
Houston, TX

Harry P. Kamen (Non-Industry)
Retired, Metropolitan Life Insurance Company
New York, NY

Raymond A. Mason (Industry)
Legg Mason, Inc.
Baltimore, MD

John Rutherfurd, Jr. (Public)
Moody's Corporation
New York, NY

Mary L. Schapiro (Staff)
NASD
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Joel Seligman (Public)
Washington University School of Law
St. Louis, MO

Sharon P. Smith (Public)
Fordham University Schools of Business
Bronx, NY

Salvatore F. Sodano (Industry)
The American Stock Exchange LLC
New York, NY

Barbara L. Weaver (Industry)
Howard Weil, Inc.
New Orleans, LA

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M. LaRae Bakerink (Industry)
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Jersey City, NJ

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Charles A. Bowsher (Public)
Former Comptroller General of the United States
Bethesda, MD

John J. Brennan (Non-Industry)
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Anthony J. Boglioli (Industry)
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