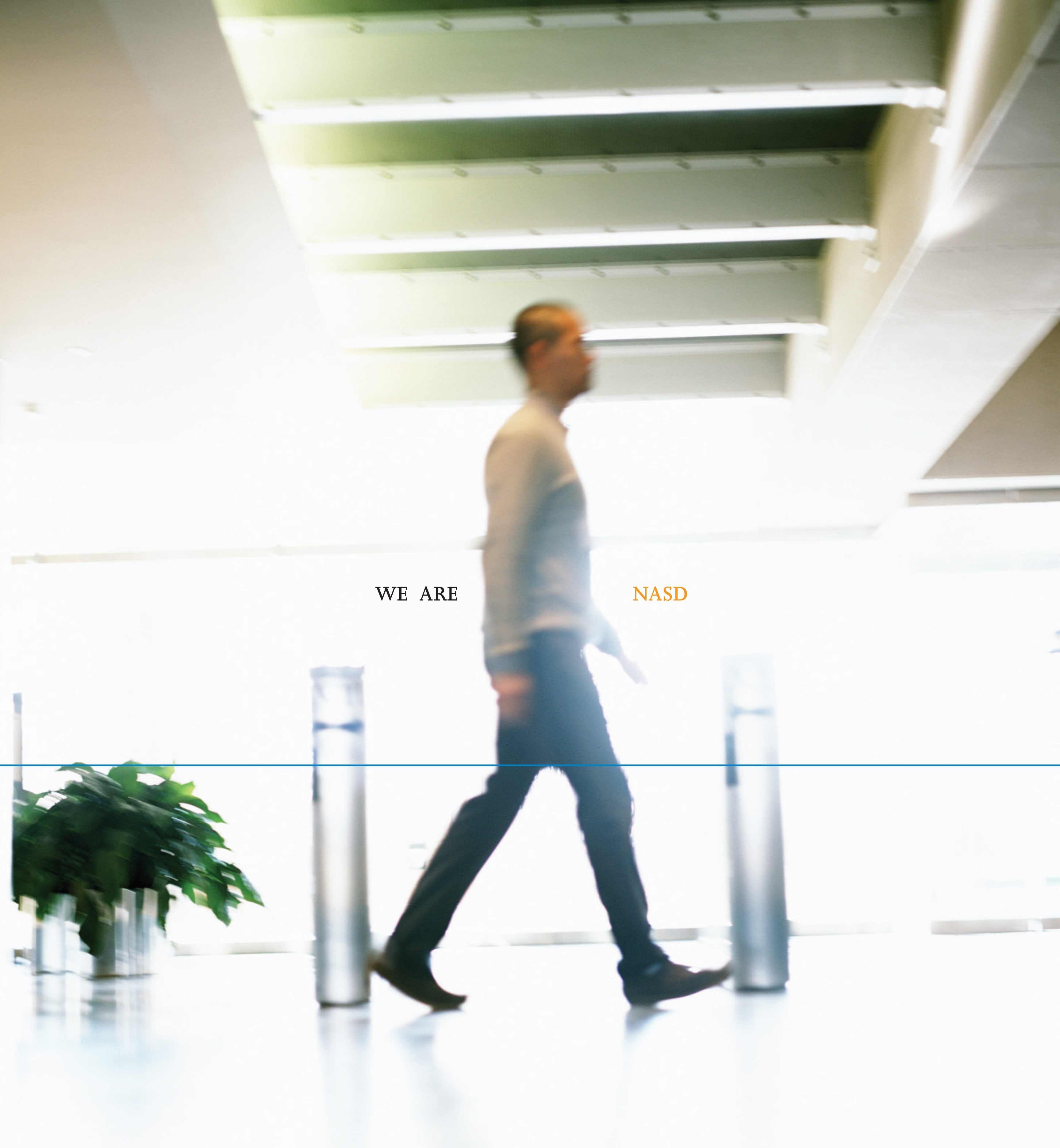
NASD

2002 ANNUAL FINANCIAL REPORT


WE ARE NASD

MESSAGE FROM THE CHAIRMAN

For everyone connected with the securities industry, 2002 was a year of great challenges. For NASD, it also was a year well spent taking sound strategic steps to deal with the present and prepare for the future. These steps fulfilled two main responsibilities. The first was to take decisive action as a regulator against practices that harmed market integrity and help the industry reform itself so as to win back investor confidence. The second was to streamline and continue improving NASD, so as to carry out our mission efficiently in a time of tight resources for us as well as the firms we regulate.

NASD'S STRUCTURE AND FINANCES

The year brought major change and progress in NASD's structure and organization. We gained our membership's overwhelming approval for NASD's restructuring as a single streamlined company — essentially moving the responsibilities of the two former regulatory subsidiaries "upstream" into NASD, and forming a new third operating division focused on regulatory services and operations. By the end of 2002, we had set the stage for fully divesting our ownership of NASDAQ, through the direct sale of shares and the sale of warrants to purchase NASDAQ shares. In operations as well as ownership, we went far in transforming NASD from the parent of NASDAQ to an independent entity focused solely on regulatory services. We also worked with an investment bank to find an appropriate buyer for Amex — a process that neared fruition in the Second Quarter of 2003 with an agreement in principle to sell Amex to the Chicago-based private equity firm, GTCR Golder Rauner.

On the fiscal front, NASD revenues increased by more than $37 million or 9 percent on record fines, better-than-expected share volumes and continued growth in arbitration filings. Operating cash flows exceeded budget by roughly 50 percent. Meanwhile, strict cost controls kept operating expenses under budget, in spite of the increased volume and scope of our activities. Through focused management and prudent investment of capital resources, we reduced our core technology spending by over $25 million, while continuing NASD's forward march in our effective use of technology. All of this allowed us to return $14 million in discretionary rebates to our members, at a time of real need. As still the legal parent of Amex and NASDAQ, NASD's financial results were all the more solid coming in the context of a dismal economic environment for the financial sector, which understandably affected the results of those entities as summarized elsewhere in this Report.

REGULATION TO RESTORE INVESTOR CONFIDENCE

NASD took unprecedented steps last year in both the enforcement and writing of rules to combat practices that harm investors and public trust in the markets. At the forefront was the most substantial, far-reaching, hardest hitting enforcement effort in NASD's six decades as a regulator. Since 2000, NASD has investigated and brought cases against some 40 firms and individuals for analyst research and initial public offering (IPO) abuses alone. This kind of tough, fair enforcement is essential to restoring confidence. Investors need to know that wrongdoers are being made to pay for their misdeeds and prevented from repeating them.

Toward that end, NASD played a major role in the $1.4 billion "global" settlement against 10 large investment houses that was announced in principle at the end of 2002 and finalized earlier this year. We took the lead in building the largest dollar cases included in the settlement. NASD's investigations of analysts Jack Grubman and Henry Blodget led to multi-million dollar fines and to their expulsion from the industry for life. We also filed charges against other prominent analysts and investment bankers, including charges still pending against technology giant Frank Quattrone for spinning and supervisory violations.

Beyond just the global settlement, NASD's 2002 enforcement program was both pioneering and unprecedented. We were the first regulator to develop substantive spinning cases. We brought more than 1,270 new enforcement actions, a record number. Even excluding our two largest fines of the year as well as the global settlement, NASD levied 25 percent more in disciplinary sanctions than ever before in its history. These funds helped NASD increase resources and staffing in the enforcement area, so that we can more quickly identify and respond to new regulatory concerns.

Of course, honest and successful markets require more than tough enforcement. They demand sound rules. And more than ever, they ask regulators to adapt to changing circumstances, see around corners and anticipate problems. That is why NASD took the lead in writing two sets of tough and far-ranging rules that have already begun to curb inflated research ratings and analyst conflicts. We prepared the ground for needed reforms in the IPO area, in part by issuing a proposed rule to ban explicitly the most prevalent initial public offering abuses, including spinning, laddering and quid pro quo arrangements. We took significant steps to help the industry comply with the extensive new anti-money laundering requirements imposed by the USA PATRIOT Act. And we established an "Ahead of the Curve" Task Force — a major initiative to anticipate, identify and respond promptly to emerging issues, which has already helped NASD take early steps in such potential problem areas as hedge funds, variable annuities and Class B share mutual fund sales.

INVESTOR EDUCATION

Healthy markets also require informed investors. Because the best investor protection often can be investor education, NASD provided a greater breadth and depth of investor education content and outreach than ever. We issued timely Investor Alerts on key topics of concern and provided thorough guidance on 529 education plans. We held a series of informative investor forums across the country. And we revamped NASD's investor Web Site — with home page traffic alone doubling to well over 20,000 visits per month.

MARKET OPERATIONS AND INFORMATION SERVICES

NASD took large strides to facilitate market efficiency and increase market transparency. We delivered on our commitment to design, build and open the Alternative Display Facility (ADF) in July 2002 — on time and within budget. This satisfied the mandate to provide a neutral facility for member firms to report quotes and trades. By year's end, ADF was already handling 3,000,000 quotes every day.

Also in July 2002, NASD rolled out our new bond market trade reporting system, TRACE — likewise on budget, operating on a breakeven basis, and with more than 1,800 client contracts signed. This was the first initiative of its kind to bring transparency to the increasingly important fixed income market. Later in the year, NASD worked successfully with the industry to gain support for both the TRACE fee structure and for broad data dissemination to more than two-thirds of the investment-grade corporate debt market.

EXPANDING NASD'S REACH

NASD made important inroads in several further areas that further our mission and vision. We expanded the regulatory services we provide to the International Securities Exchange. We moved into regulation of security futures trading by regulating NASDAQ-Liffe and facilitating its smooth market opening. And we contracted with the innovative Chicago Climate Exchange to provide a full range of regulatory services.

HOLDING DOWN MEMBER COSTS AND BURDENS

NASD is determined to take every appropriate step to hold down member costs and burdens. Though this year's financial conditions will make it difficult to duplicate, the $14 million discretionary rebate we returned to members in 2002 made it the second year in a row NASD managed such an unscheduled rebate of at least $10 million. The year also saw other steps to limit member burdens. For example, we listened to member concerns about arbitration costs in investor claims that arbitrators deem unfounded. As a direct result, NASD made changes that we estimate may result in refunds of arbitration surcharges to our members of more than $250,000 per year.

EXTENDING OUR LEADERSHIP IN DISPUTE RESOLUTION

The availability of fair, effective and low-cost means of resolving disputes between investors and brokers has never been more important to market integrity and investor confidence. And in the 30-year history of NASD's dispute resolution program, we have never filled this need more capably. In 2002, NASD Dispute Resolution again set an all-time record for volume, with continued high quality service. Arbitration filings grew 11 percent to more than 7,700. This represented a two-year increase of nearly 40 percent — with 2003 filings to date surging perhaps 25 percent more.

NASD handled last year's mushrooming caseload with modest increases in headcount and overhead. This kind of disciplined management enabled Dispute Resolution (DR) to move from operating at a loss as recently as 2000 to an operating surplus. At the same time, DR improved the quality of its roster of neutral arbitrators and mediators; doubled constituent use of its Web Site; made DR hearings available in three new locations; upgraded its Washington, D.C. satellite location to full regional office status; streamlined its procedures; and consolidated its San Francisco and Los Angeles offices without disruption to parties or arbitrators.

NASD's dispute resolution services spare the parties to a securities dispute much of the expense, time and trouble of traditional court litigation. And of all the customer cases brought to NASD arbitrators and mediators, two-thirds result in a monetary recovery to the investor, either through settlement or an arbitration award.

CONCLUSION

NASD will continue to do all that it takes to help restore markets fully worthy of investor faith. We will keep striving to strike a responsible balance between the aggressive enforcement and new rules that many public voices clamor to see, and the risks of overreaction that history shows are inevitable at times such as this. Above all, with the help of our regulatory partners, the SEC, Congress, the industry and the public at large, we will strive to protect investors and give them lasting confidence that America's markets are not only highly liquid and developed, but still the most admired, transparent and trusted in the world.

For such confidence is the bedrock on which our financial markets rest. And especially now, it is the one asset that deserves the label of "priceless."

Robert R. Glauber
Chairman and Chief Executive Officer
July 1, 2003

As the world's leading private-sector provider of financial regulatory services, NASD's mission is investor protection and market integrity. NASD registers member firms, writes rules to govern their behavior, examines them for compliance and disciplines those that fail to comply. We provide education to industry professionals and investors. We also operate the largest securities dispute resolution forum – with arbitration and mediation programs – in the world.

The following statistics are intended to provide a snapshot of the role played by NASD in helping to protect investors and bring integrity to the markets. All statistics are for the calendar year 2002.

Broker/dealers regulated by NASD	5,392
Broker/dealer Branch Offices	91,473
Registered Representatives	662,311
NASD Employees	2,087

INVESTOR COMPLAINTS

Customer Complaints Received	5,982
Customer Complaints Resolved	4,611

NASD PUBLIC DISCLOSURE PROGRAM

NASD's Public Disclosure Program provides the public with a resource for checking the professional background, registration/license statuses and conduct of NASD registered firms and their registered brokers. Any member of the public can search for an individual or a firm and if the search finds that disclosable information is available, request a report.

Successful searches for an individual or a firm	over 2.5 million
Reports generated	194,295

REGULATORY ACTIONS

Firms expelled from the industry	25
Firms suspended	5
Individuals barred from the industry	440
Individuals suspended	374
New disciplinary actions filed	1,271
Formal actions resolved	1,129
Advertisements and Sales	
Communication Reviewed	87,855

TESTING AND CONTINUING EDUCATION

Qualification Exams	
NASD Exams	150,008
Other	121,384
Continuing Education Sessions	271,392

CORPORATE BOND TRANSPARENCY

NASD's Trade Reporting and Compliance Engine (TRACE) facilitates the mandatory reporting of over the counter secondary market transactions in eligible fixed income securities. These statistics are for July 1, 2002 – December 31, 2002.

Corporate Bond Volume Reported to the System	2.3 trillion dollars
Corporate Bond Trades Reported to the System	3.1 million trades
Percent of Investment Grade Volume Reported to the Public	45%
Percent of Investment Grade Trades Reported to the Public	39%

MARKET SURVEILLANCE

Each trading day, NASD monitors some 70 million quotes, orders and trades. In the calendar year 2002, NASD monitored about 1.2 trillion shares reported to NASDAQ and the Alternative Display Facility for Small Cap, CQS, OTC, and OTCBB.

CORPORATE FINANCING

Equity Filings	551
Debt Filings	70
Other Corporate Filings	56
Total Corporate Filings	677
Other Filings	88
Grand Total	765

DISPUTE RESOLUTION

ARBITRATION

Cases filed	7,704
Cases closed	5,957

How arbitration cases were closed:

Closed after hearing	1,463
Closed after review of documents	443
Settled by the parties	2,204
Settled by mediation	752
Withdrawn	547
*All other	489

*(Including Stipulated Awards, Bankruptcies, Deficient Claims, etc.)

NOTE: This breakout does not include cases closed and later reopened.

MEDIATION

Cases brought	936
Cases closed	1,360
Cases settled	1,110

CONTENTS

THE PREEMINENT
PRIVATE-SECTOR REGULATOR

WE ARE NASD

OVERVIEW

The year 2002 was one of great turmoil for the securities markets and corporate America. In this climate of scandal and shaken investor confidence, the work of the National Association of Securities Dealers, Inc. ("NASD") as a tough and fair regulator has never been more important.

Throughout the year, NASD played a leading role in some of the largest enforcement actions ever seen in the securities industry, involving research analysts and Initial Public Offering ("IPO") abuses, and it developed important new rules in these and other areas as well. NASD made important advances in streamlining its organization and practices, so as to carry out its mission efficiently and effectively in a time of limited resources for it as well as member firms. NASD restructured several major member regulatory fees and pricing arrangements. Finally, NASD successfully introduced important new market operations, information systems, and technologies — all while realizing substantial savings against projected technology spending.

NASD took major strides in 2002 to further divest itself of securities markets operations. In March 2002, NASD completed one of the final steps in the divestiture of The Nasdaq Stock Market, Inc. ("NASDAQ"), with the sale of an additional 33.8 million shares of NASDAQ common stock. This sale brought closer to fruition — pending Securities and Exchange Commission ("SEC") approval of NASDAQ's exchange registration — the desired full operational separation of the two companies. NASD also took significant steps to sell New NASD Holding, Inc.'s interest in The American Stock Exchange, LLC ("Amex"), by working closely with an investment banker in marketing Amex to potential buyers.

The 2002 consolidated financial statements reflect the combined activity of NASD, NASDAQ, and Amex, including the anticipated loss on the sale of Amex. (References to NASD and its consolidated subsidiaries throughout are collectively referred to as "the Company.") In a difficult market environment, total financial performance for the combined entities remained both relatively solid and consistent. Consolidated net operating income declined $1.5 million or 2 percent to $89.0 million in 2002. Consolidated revenues declined $29.5 million or 2 percent to $1.238 billion. Consolidated expenses declined by $28.0 million or 2 percent to $1.149 billion.

INVESTOR PROTECTION AND MARKET INTEGRITY

Throughout 2002, NASD was at the forefront of regulatory matters, working closely with the SEC to reach a landmark $100.0 million settlement with Credit Suisse First Boston ("CSFB") for taking paybacks from favored customers in exchange for allocations of "hot" IPOs. NASD's share of this settlement was $50.0 million — one of the largest sanctions in its history. NASD also played a major role in the $1.4 billion global settlement with large investment houses that was announced in late 2002 and finalized in the spring of 2003. All told, NASD brought more new disciplinary actions and barred or suspended more individuals in 2002 than ever before in its history.

NASD's rule-writers were equally busy and influential — taking the lead in developing two sets of rules to curb research analyst conflicts of interest, and issuing a proposed rule to prohibit explicitly the most widespread kinds of IPO allocation abuses. In addition, NASD undertook 100 percent of its required 2,661 cycle exams (a key SEC measure of NASD effectiveness), and commenced investigation of 4,500 customer complaints, 4,537 terminations for cause, and 2,263 other cause matters.

The year 2002 was another record year for NASD Dispute Resolution, with 7,704 new arbitration cases filed. This represented an increase of 11 percent over 2001 and a two-year increase of more than 39 percent. NASD arbitrators awarded damages totaling $139 million in 2002, compared to $97 million in 2001. Mediation activity grew as well, with more than 80 percent of the cases brought to an NASD mediator successfully reaching settlement.

NEW SYSTEMS, PRODUCTS AND TECHNOLOGIES

NASD delivered two major new market information systems in 2002. The Trade Reporting and Compliance Engine ("TRACE") received SEC approval and was launched — on time and within budget — to bring added information and transparency to the nation's bond markets. The Alternative Display Facility ("ADF") was rolled out on an equally timely and successful basis, to satisfy the mandate to provide a neutral facility for NASD members to report quotes and trades.

In 2002, NASD deployed several new systems, products and technologies such as the surveillance and exam element "toolbox" features of INSITE, which assist in the conducting of routine examinations. In addition, NASD developed and deployed SONAR, an advanced analytical tool for identifying potential trading violations.

PRICING

NASD modified pricing for several of its member revenue streams in 2002. Pricing for NASD's Gross Income Assessment Fee was simplified, eliminating deductions and exclusions and instead applying a three-tiered flat rate structure to gross FOCUS revenues. Personnel Assessment Fees were increased to more appropriately apportion billings with member regulatory activities. Finally, NASD implemented a pilot program to replace the NASD Regulatory Fee with a new Trading Activity Fee ("TAF"), the key premise of which was to establish billings based on all transactions in all markets, rather than only transactions routed through NASDAQ or over-the-counter.

COST SAVINGS & MEMBER REBATES

Despite challenges presented by the regulatory and market environment in 2002, NASD approved and paid the largest discretionary rebates to its membership in its history. While $10.0 million was approved and paid in accordance with the NASDAQ Private Placements, NASD paid an additional $14.0 million special discretionary rebate in order to assist its members at a time of real need for the industry.

NASDAQ RESTRUCTURING

In 2002, NASD and NASDAQ moved a final step closer to completing the separation of the two entities that was first decided upon in 2000. In March 2002, NASD sold an additional 33.8 million shares of NASDAQ common stock to NASDAQ, reducing its ownership of NASDAQ to roughly 55 percent 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 and issued 1,338,402 of Series A Preferred Stock, as well as one share of Series B Preferred Stock.

With its 55 percent 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. Once 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 and NASD will no longer exert voting control. Upon exchange registration, NASD will cease to consolidate NASDAQ's operations with NASD's results. The exact timing of exchange registration is currently unknown.

Previous NASD transactions in NASDAQ stock include the Phase I and Phase II of 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.

The table below summarizes the effect of all NASD and NASDAQ transactions in NASDAQ stock during the period June 2000 to December 2002.

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 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	(0.3)%	–	(20,830)	(1.0)	(1.2)	–	2.2
Ending Balance/Cumulative Year Ended 12/31/02	**55.2%**	**–**	**43,205,146**	**$ (371.4)**	**$ (18.9)**	**(368.6)**	**$ (758.9)**
Cash Proceeds – NASD*							$ 730.8
Cash Proceeds – NASDAQ**							28.1
Total Cash Proceeds							**$ 758.9**

* 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, 2002, 20,830 shares had been purchased through the exercise of warrants. The first exercise period expires on June 27, 2003.

Transfer restrictions on NASDAQ common stock expired on June 28, 2002, enabling NASDAQ shares to be sold in compliance with either Rule 144 of the Securities Act of 1933 ("Securities Act") or under an exemption from registration requirements of Section 5 of the Securities Act. Trading that takes place in NASDAQ stock is captured on the Over-The-Counter Bulletin Board under the symbol NDAQ. With the lifting of sale restrictions, a vehicle for net settlement was created, a condition previously exempting NASD from treating warrants to purchase NASDAQ stock as a derivative instrument. With transfer restrictions removed, NASD began marking the outstanding warrants to market and recognized a $104.7 million gain in 2002 as a result.

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	June 28, 2002 – 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

AMEX SALE

Consistent with NASD's objective of divesting itself of the operation of exchanges, NASD began working with an investment banker to find an appropriate buyer for Amex. By the end of 2002, NASD and its investment banker had narrowed the list of potential buyers to a select few, and on May 30, 2003, NASD reached an agreement in principle to sell Amex to a Chicago-based private equity firm, GTCR Golder Rauner LLC. The terms of this specific agreement are subject to the completion of definitive sale documents and approvals by NASD's Board of Governors, Amex's Board of Governors, Amex membership, and the Securities and Exchange Commission. NASD has accounted for Amex as a discontinued operation as of December 31, 2002.

RESULTS OF OPERATIONS

Returning to financial results, the table below provides condensed information on the 2002, and 2001 continuing operations of the Company by major business segment.

NASD CONSOLIDATED FINANCIAL PERFORMANCE BY SEGMENT (DOLLARS IN MILLIONS)

	NASD		NASDAQ		Consolidating Adjustments		Total	
	2002	2001	2002	2001	2002	2001	2002	2001
Revenues	$446.6	$409.4	$799.3	$859.9	$(8.4)	$ (2.3)	$1,237.5	$1,267.0
Expenses	(430.8)	(383.0)	(707.7)	(781.5)	(10.0)	(12.0)	(1,148.5)	(1,176.5)
Net operating income	15.8	26.4	91.6	78.4	(18.4)	(14.3)	89.0	90.5
Other income (expense)	101.9	73.6	(48.5)	(37.9)	(24.7)	(26.2)	28.7	9.5
Income (loss) from continuing operations	$117.7	$100.0	$43.1	$40.5	$(43.1)	$(40.5)	$117.7	$100.0
(Loss) income from discontinued operations	(121.2)	12.0	0.0	0.0	0.0	0.0	(121.2)	12.0
Net income (loss)	**$ (3.5)**	$112.0	**$43.1**	$40.5	**$(43.1)**	$(40.5)	**$ (3.5)**	$112.0

REVENUES

For the year ended December 31, 2002, total consolidated revenues decreased $29.5 million or 2 percent, with NASD contributing an increase of $37.2 million and NASDAQ contributing a decrease of $60.6 million, respectively, before consolidating adjustments.

Driving increases in NASD revenues were record fines and escalating arbitration case volumes, offset by declines in member assessment revenues and regulatory service fees. Fines revenue increased by approximately $55 million. Arbitration fees increased $15.2 million or 34 percent. Member assessments declined $31.1 million or 25 percent tied to overall lower firm FOCUS revenues and increases in member rebates of roughly $7 million. Regulatory service fees declined roughly $10 million or 10 percent due to both reduced market volumes and a change in the overall billing structure for these fees. NASDAQ average daily share volumes, a traditional benchmark for NASD regulatory service fees, declined 8 percent, from 1.900 billion in 2001 to 1.753 billion in 2002. In October 2002, NASD implemented a pilot program to replace its previous regulatory service fee with a new trading activity fee, providing a discount for such services and changing the basis for this billing from only those transactions occurring on NASDAQ to all transactions on all markets.

NASDAQ revenue declines were tied primarily to declines in transaction services and market information service revenues, offset by an increase in issuer services revenues. Declines in transaction service and market information service revenues were tied primarily to declines in the number of devices and subscriptions due to cost savings initiatives among NASDAQ market participants. Reduced share and trading volumes and increased revenue sharing under NASDAQ's Unlisted Trading Privileges Plan also contributed to this decline. Offsetting decreases in these revenue streams were increases in issuer services revenues due mainly to a revised NASDAQ fee structure for annual renewals.

EXPENSES

Turning to expenses, consolidated expenses declined $28.0 million or 2 percent in 2002, with NASD contributing an increase of $47.8 million and NASDAQ contributing a decline of $73.8 million, respectively, before consolidating adjustments.

Driving approximately 60 percent of the increase in NASD expenses were increases in infrastructure related costs associated related to the continued separation of NASDAQ and Amex from NASD. Other increases in NASD expenses were related to the replacement of key data center equipment and increased compensation associated with increased headcount for enforcement activities. Offsetting these increases were declines in computer operations and communications expenses associated with the renegotiation of maintenance and software licensing contracts and declines in depreciation expense associated with the replacement of datacenter hardware in favor of more efficient and less costly technology.

Decreases in NASDAQ expenses were tied mainly to reductions in computer operations and data communications and other expenses. Computer operations expenses declined significantly due to a renegotiation of NASDAQ's contract with WorldCom in 2002, as well as lower costs associated with providing computer links to customers due to lower demand for such services.

OTHER INCOME (EXPENSE)

Other income (expense) represents the combined impact on net income from non-operating activities, such as interest income, interest expense, net realized investment (losses) gains, net (losses) income from equity investments, income taxes, gains on sale of NASDAQ shares, and changes in market value of warrants to purchase NASDAQ stock sold by NASD. Other income increased $19.2 million in 2002 with NASD contributing a net increase in other income of $28.3 million and NASDAQ offsetting this with an increase in other expense of $10.6 million.

NASD increases in other income reflect an increase from the $104.7 million gain from the change in the market value of warrants sold in 2002, offset by the $31.4 million gain on sale of NASDAQ stock in 2001, and increased net realized losses on its investment portfolio in 2002. NASDAQ increases in other expense were tied primarily to additional losses from equity-method subsidiaries.

(LOSS) INCOME FROM DISCONTINUED OPERATIONS

The net (loss) income from discontinued operations of ($121.2) million and $12.0 million for December 31, 2002, and 2001, respectively, represents the operations of Amex for the period, net of intercompany eliminations and taxes, and including adjustments applied in 2002, to measure Amex at the estimated fair value less costs to sell. The total gross adjustment in 2002 for the difference in fair value less cost to sell Amex is estimated to be $134.6 million.


A STANDARDS-SETTER
NASD
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NASD MANAGEMENT REPORT ON FINANCIAL REPORTING RESPONSIBILITY

Management is responsible for the preparation, integrity, and objectivity of the consolidated financial statements of the National Association of Securities Dealers, Inc., (“NASD”). This responsibility includes the selection and application of accounting principles generally accepted in the United States. These consolidated financial statements reflect informed judgments and estimates that management believes to be reasonable in determining certain information used in the accounting and reporting process. The consolidated financial statements have been prepared in conformity with these principles and are free of material misstatement.

NASD maintains an effective system of internal accounting controls that is periodically modified and improved to correspond with changes in NASD’s operations. This system of internal controls is designed to provide reasonable assurance that the assets of NASD are safeguarded against loss from unauthorized use or disposition and that the books and records, from which the consolidated financial statements were prepared, properly reflect the financial transactions of NASD. Important elements of the internal control system include capital and operating budgets, which are subjected to continuous review and reporting throughout the year; an organizational structure providing segregation of responsibilities; established policies and procedures; careful selection and training of qualified personnel; and an internal audit program developed and carried out by NASD's Internal Audit Department, which reports directly to the Audit Committee of the NASD Board of Governors. It is management’s opinion that the system of internal control as of December 31, 2002, is effective in providing reasonable assurance that the consolidated financial statements are free of material misstatement.

The Board of Governors of NASD establishes charters for its Audit and Finance Committees. The Audit Committee provides assistance to the Board of Governors in fulfilling its oversight responsibility relating to NASD’s financial statements and the financial reporting process, the systems of internal accounting and financial controls, the internal audit function, the annual independent audit of NASD’s financial statements, and monitoring the independence of the independent auditors. The Finance Committee oversees the financial operations and condition of NASD through reviews and discussions with management of current financial results, annual operating and capital budgets and material modifications thereto, and all other financial matters related to the operation and financial position of NASD. The Finance Committee, with the exception of the Chairman and Chief Executive Officer of NASD, consists of non-employee governors, one-half of which are non-industry members.

NASD MANAGEMENT REPORT ON FINANCIAL REPORTING RESPONSIBILITY

NASD's independent auditors, Ernst & Young LLP ("Ernst & Young"), have conducted an audit of the consolidated financial statements of NASD for the years ended December 31, 2002, and 2001, in accordance with auditing standards generally accepted in the United States. Representatives of Ernst & Young have met with NASD management and with members of the Audit Committee of the Board of Governors, with and without management present, to discuss the results of their audits and other accounting, auditing, and financial matters.

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. In addition, the Audit Committee has determined that James E. Burton is an audit committee financial expert, 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 2002, the Committee met eight times, with all Committee members participating in all meetings.

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 auditors' 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 audit and non-audit services, before initiation of each engagement, performed by NASD's independent auditors, Ernst & Young, and the associated fees. Such services and fees are summarized in the following table:

INDEPENDENT PUBLIC ACCOUNTANT (IPA) FEES

	NASD		NASDAQ (4)		AMEX		TOTAL	
	2002	2001	2002	2001	2002	2001	2002	2001
Audit services (1)	$424,300	$399,071	$1,653,492	$725,000	$187,700	$272,254	$2,265,492	$1,396,325
Audit-related services (2)	379,093	247,816	2,328,333	1,980,000	55,767	75,859	2,763,193	2,303,675
Tax services	122,240	223,521	286,471	300,000	84,618	55,434	493,329	578,955
Other services (3)	7,485	29,000	1,235,361	1,600,000	–	–	1,242,846	1,629,000
Total	**$ 933,118**	$899,408	**$5,503,657**	$4,605,000	**$328,085**	$403,547	**$ 6,764,860**	$5,907,955

(1) Audited services for NASD and Amex reflect fees associated with the year-end audits. NASDAQ audit services associated with the audit of the annual financial statements and the review of NASDAQ's quarterly reports on Form 10-Q.

(2) Audit related services for NASD and Amex reflect fees associated with special purpose audits such as CRD, CTA/CQS, and IARD, as well as audit related services associated with the planned disposition of Amex. NASDAQ audited related services for 2002 reflect fees associated with transactional due diligence related to global strategic initiatives ($1.9 M) and accounting advisory services ($.4 M). NASDAQ audit related services for 2001 reflect fees associated with SEC registrations and consents ($1.7 M) and accounting consultations ($.2 M).

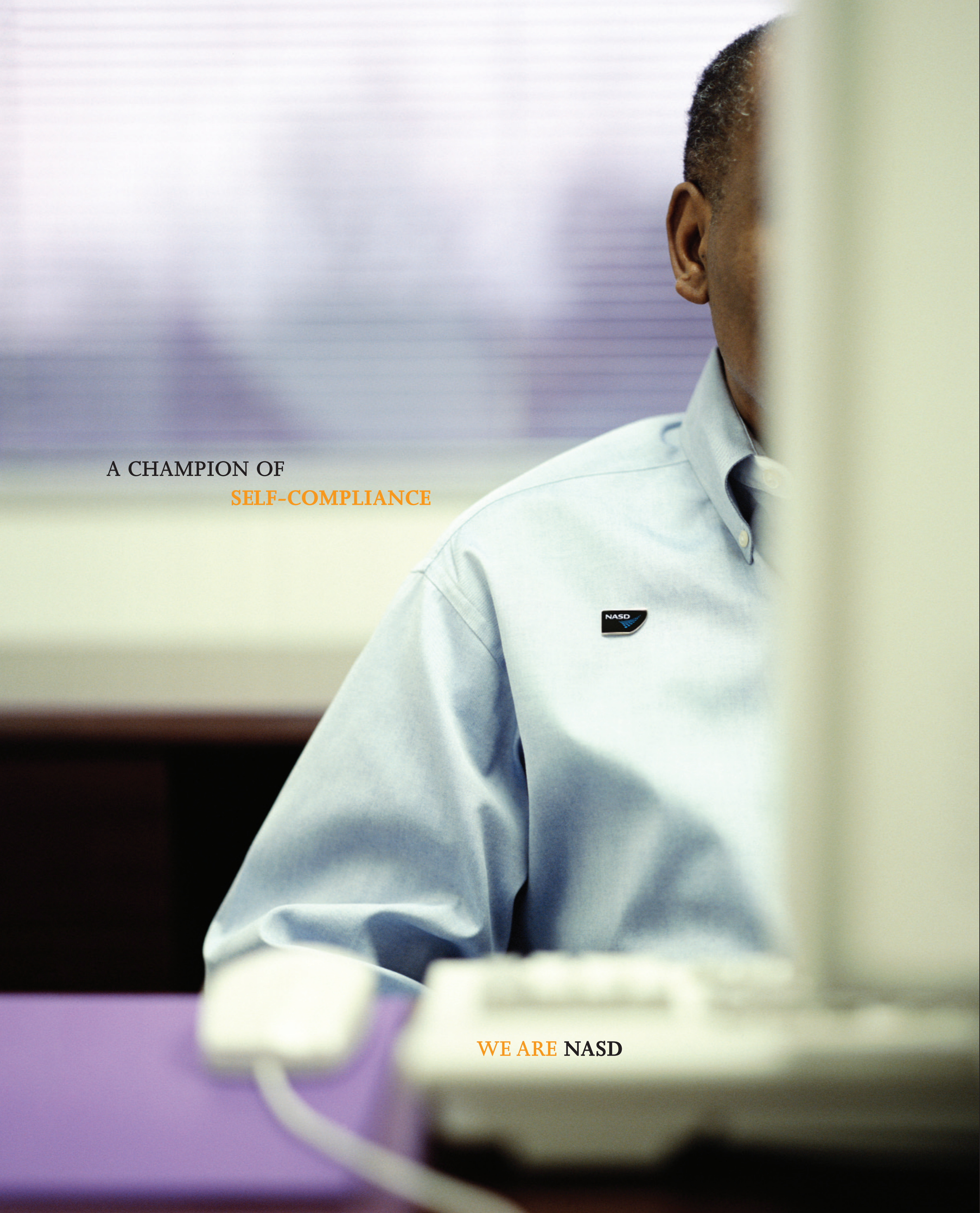
(3) Other NASDAQ services include fees associated with internal audit co-sourcing of $1.2 M and $1.4 M for 2002 and 2001, respectively.

(4) 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.

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, 2002.

Members of the Audit Committee:

James E. Burton, Chairman
John W. Bachmann
M. LaRae Bakerink
Eugene Isenberg
Sharon P. Smith



A CHAMPION OF
SELF-COMPLIANCE

WE ARE NASD

REPORT OF INDEPENDENT AUDITORS

Board of Governors
National Association of Securities Dealers, Inc.
d/b/a NASD

We have audited the accompanying consolidated balance sheets of the National Association of Securities Dealers, Inc. d/b/a NASD ("NASD") as of December 31, 2002 and 2001, 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, 2002 and 2001, 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 4, 2003, except for Note 18
as to which the date is
June 26, 2003

NASD CONSOLIDATED BALANCE SHEETS *(Dollars in thousands)*

	December 31, 2002	December 31, 2001
ASSETS		
Current assets:		
Cash and cash equivalents	**$ 473,837**	$ 549,748
Investments:		
Available-for-sale, at fair value	**1,092,024**	743,772
Held-to-maturity, at amortized cost	**18,674**	–
Receivables, net	**194,380**	227,806
Deferred tax assets	**53,048**	51,171
Other current assets	**32,593**	24,937
Current assets – discontinued operations	**123,565**	112,000
Total current assets	**1,988,121**	1,709,434
Held-to-maturity investments, at amortized cost	**9,728**	28,570
Property and equipment:		
Land, buildings and improvements	**167,082**	168,779
Data processing equipment and software	**621,756**	630,778
Furniture, equipment and leasehold improvements	**323,572**	338,496
	1,112,410	1,138,053
Less accumulated depreciation and amortization	**(573,672)**	(541,745)
Total property and equipment, net	**538,738**	596,308
Non-current deferred tax assets	**69,971**	93,715
Other assets	**84,745**	64,817
Non-current assets – discontinued operations	**50,641**	157,900
Total assets	**$ 2,741,944**	$ 2,650,744

See accompanying notes.

NASD CONSOLIDATED BALANCE SHEETS *(Dollars in thousands)*

	December 31, 2002	2001
LIABILITIES AND MEMBERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	**$ 137,407**	$ 151,286
Net SEC fees	**60,526**	82,811
Accrued personnel costs	**112,302**	102,330
Deferred revenue	**106,201**	105,288
Short-term borrowings	**11,329**	–
Deposits and renewals	**68,423**	57,295
Capital lease obligation	**4,396**	4,454
Due to custodial agent	**131,084**	27,927
Other current liabilities	**41,346**	46,988
Current liabilities – discontinued operations	**99,478**	119,469
Total current liabilities	**772,492**	697,848
Accrued pension costs and other postretirement benefit costs	**33,190**	38,552
Long-term debt	**429,689**	288,548
Non-current deferred tax liabilities	**49,240**	72,295
Non-current capital lease obligation	**7,735**	12,125
Deferred revenue	**102,065**	121,687
Warrants to purchase NASDAQ stock from NASD	**23,825**	128,492
Other liabilities	**12,109**	34,546
Non-current liabilities – discontinued operations	**82,135**	48,082
Total liabilities	**1,512,480**	1,442,175
Minority interests	**54,908**	166,535
Commitments and contingencies		
Members' equity	**1,173,487**	1,054,164
Unrealized gain (loss) on available-for-sale investments	**5,374**	(6,469)
Foreign currency translation	**(217)**	(4,700)
Minimum pension liability	**(4,088)**	(961)
Total members' equity	**1,174,556**	1,042,034
Total liabilities and members' equity	**$ 2,741,944**	$ 2,650,744

See accompanying notes.

NASD CONSOLIDATED STATEMENTS OF INCOME *(Dollars in thousands)*

	YEARS ENDED DECEMBER 31, 2002	2001
REVENUES		
Transaction services	**$ 379,323**	$ 408,769
Market information	**205,414**	240,524
Issuer services	**176,671**	156,124
Member assessments, net of member rebates of $24,000 in 2002 and $17,000 in 2001	**93,580**	124,659
Regulatory service fees	**93,917**	103,938
Registration fees	**71,026**	70,132
Arbitration fees	**59,589**	44,361
Qualification fees	**37,685**	42,205
Fines	**68,234**	13,304
Corporate financing fees	**10,454**	10,198
Other	**41,579**	52,784
Total revenues	**1,237,472**	1,266,998
EXPENSES		
Compensation and benefits	**426,399**	415,146
Professional and contract services	**205,843**	197,034
Computer operations and data communications	**167,082**	197,844
Depreciation and amortization	**152,577**	149,121
Occupancy	**58,967**	55,878
Marketing and advertising	**27,125**	28,261
Publications, supplies and postage	**26,355**	29,172
Travel, meetings and training	**26,900**	27,113
NASDAQ Japan impairment loss	**15,208**	–
Other	**42,011**	76,943
Total expenses	**1,148,467**	1,176,512
Net operating income	**89,005**	90,486
OTHER INCOME (EXPENSE)		
Interest and dividend income	**50,669**	59,351
Interest expense	**(19,766)**	(11,475)
Net realized investment losses	**(49,014)**	(12,636)
Gain on sale of NASDAQ shares by NASD	**–**	31,445
Gain in NASDAQ warrants	**104,667**	–
Net losses from equity investees	**(12,065)**	(14,124)
Minority interest expense	**(4,721)**	(4,726)
Income before income taxes and discontinued operations	**158,775**	138,321
Provision for income taxes	**(41,049)**	(38,332)
Income from continuing operations	**117,726**	99,989
(Loss) income from discontinued operations (net of tax benefits of $12,336 in 2002 and $3,163 in 2002)	**(121,206)**	12,010
NET (LOSS) INCOME	**$ (3,480)**	$ 111,999

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, 2000	$ 868,952	$ 51	$ 869,003
Net income	111,999	–	111,999
Unrealized loss on available-for-sale investments, net of tax of ($1,030), net of minority interests of ($284)	–	(8,302)	(8,302)
Foreign currency translation, net of minority interests of $2,029 and net tax of ($380)	–	(2,918)	(2,918)
Minimum pension liability, net of tax of ($900), net of minority interests of ($434)	–	(961)	(961)
Comprehensive income	–	–	99,818
Increase in equity attributable to the issuance of stock by NASDAQ and its subsidiaries	38,998	–	38,998
Increase in equity attributable to Hellman & Friedman transaction	40,535	–	40,535
Decrease in equity attributable to the purchase of minority interests in NASDAQ Europe Planning Company Limited, net of minority interest of $3,203	(9,197)	–	(9,197)
Increase in equity attributable to amortization of restricted stock awards by NASDAQ, net of minority interest of $1,238	2,877	–	2,877
Balance, December 31, 2001	**1,054,164**	**(12,130)**	**1,042,034**
Net loss	**(3,480)**	**–**	**(3,480)**
Unrealized loss 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 interests 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**

See accompanying notes.

NASD CONSOLIDATED STATEMENTS OF CASH FLOWS *(Dollars in thousands)*

	YEARS ENDED DECEMBER 31, 2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES		
Net (loss) income	**$ (3,480)**	$ 111,999
Adjustments to reconcile net (loss) income to cash provided by operating activities:		
Depreciation and amortization	**152,577**	149,121
Gain on sale of NASDAQ shares by NASD	**–**	(31,445)
Gain on NASDAQ warrants	**(104,667)**	–
Loss from discontinued operations	**134,600**	–
Stock-based compensation	**3,155**	6,883
Net realized losses on investments	**15,327**	7,521
Investment impairment charges	**33,687**	5,115
Fixed asset impairment charges	**–**	7,177
Loss on disposal of fixed assets	**23,248**	–
NASDAQ Japan impairment loss	**15,208**	–
Losses from equity investees	**12,065**	14,124
Bad debts expense	**13,009**	23,734
Minority interest expense	**4,721**	4,726
Interest income accretion	**(100)**	(7,919)
Other net non-cash income items	**(2,443)**	(3,402)
Net change in operating assets and liabilities, net of effects of acquisitions:		
Receivables, net	**20,417**	(36,763)
Deferred tax assets	**22,784**	(47,246)
Other current assets	**(19,121)**	62,253
Other assets	**(39,488)**	(81,081)
Accounts payable and accrued expenses	**(13,879)**	(44,771)
Accrued personnel costs	**7,172**	(3,913)
Deferred revenue	**(18,709)**	(22,369)
Deposits and renewals	**11,128**	18,592
Due to custodial agent	**103,157**	27,761
Other current liabilities	**(25,633)**	18,307
Accrued pension and other post-retirement costs	**(7,294)**	11,389
Deferred tax liabilities	**(23,055)**	28,420
Other liabilities	**11,616**	(36,803)
NET CASH PROVIDED BY OPERATING ACTIVITIES	**326,002**	181,410
CASH FLOW FROM INVESTING ACTIVITIES		
Proceeds from redemptions of available-for-sale investments	**3,245,736**	2,680,606
Purchases of available-for-sale investments	**(3,640,079)**	(2,922,546)
Proceeds from maturities of held-to-maturity investments	**–**	25,465
Purchases of held-to-maturity investments	**–**	(25,455)
Net proceeds from the sale of NASDAQ shares by NASD in Phase II	**–**	53,474
Net proceeds from the sale of warrants in NASDAQ stock sold by NASD in Phase II	**–**	59,827
Acquisition, net of cash acquired	**–**	6,990
Capital contribution to NASDAQ LIFFE joint venture	**(16,000)**	(2,000)
Capital contribution to NASDAQ Deutschland AG	**(6,100)**	–
Purchases of property and equipment, net	**(114,743)**	(147,778)
NET CASH USED IN INVESTING ACTIVITIES	**$ (531,186)**	$ (271,417)

See accompanying notes.

NASD CONSOLIDATED STATEMENTS OF CASH FLOWS *(Dollars in thousands)*

	YEARS ENDED DECEMBER 31, 2002	2001
CASH FLOW FROM FINANCING ACTIVITIES		
Net proceeds from newly issued NASDAQ stock in Phase I and II	**$ –**	$ 63,688
Purchase of minority shareholders interests in NASDAQ Europe Planning Company Limited	**–**	(27,361)
Net proceeds from the purchase of NASDAQ shares by employees and directors	**2,238**	14,079
Proceeds from issuance of debt	**152,470**	251,592
Debt repayment	**–**	(50,000)
Decrease in net SEC fees	**(22,285)**	(98,930)
Proceeds from issuance of stock by subsidiaries	**1,298**	16,058
Principal payments on capital leases	**(4,448)**	(7,499)
NET CASH PROVIDED BY FINANCING ACTIVITIES	**129,273**	161,627
(Decrease) increase in cash and cash equivalents	**(75,911)**	71,620
Cash and cash equivalents at beginning of year	**549,748**	478,128
CASH AND CASH EQUIVALENTS AT END OF YEAR	**$ 473,837**	$ 549,748
SUPPLEMENTAL DISCLOSURES:		
Cash payments for interest	**$ 15,820**	$ 11,400
Cash payments for taxes	**$ 79,117**	$ 26,844
SCHEDULE OF NONCASH INVESTING ACTIVITIES:		
Purchases of property and equipment under capital lease	**$ 225**	$ 8,119

See accompanying notes.

(Dollars in tables in thousands)

1. ORGANIZATION AND NATURE OF OPERATIONS

The National Association of Securities Dealers, Inc. d/b/a NASD ("NASD"), a Delaware corporation, is the majority owner of The NASDAQ Stock Market, Inc. ("NASDAQ"), and wholly owns the following significant subsidiaries: The American Stock Exchange LLC ("Amex"), NASD Regulation, Inc. ("NASDR"), NASD Dispute Resolution, Inc. ("NASD DR") and New NASD Holding, Inc. ("NASD Holding"); collectively referred to as the Company.

NASD oversees the activities of the U.S. broker/dealer profession and regulates NASDAQ and the over-the-counter securities markets. NASDR carries out NASD's regulatory functions, including onsite examinations of member firms, continuous automated surveillance of markets operated by NASDAQ, and disciplinary actions against broker/dealers and their professionals. NASD DR provides arbitration and mediation services to assist in the resolution of disputes between investors and securities firms. NASD Holding holds the Company's interest in the Amex. Amex uses a specialist system to operate a floor-based exchange. NASDAQ uses a multiple market maker system to operate an electronic, screen-based equity market. NASDAQ's principal business products are price discovery and trading services, listing of issues, and the sale of related data and information.

At a special meeting of NASD members held 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 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 of the Restructuring closed on June 28, 2000, yielding net proceeds to NASD and NASDAQ of $72.2 million and $253.3 million, respectively. As of December 31, 2000, NASD owned 80.6% of NASDAQ on a non-diluted basis. During Phase I of the Restructuring, NASD sold warrants to purchase shares of the Common Stock of NASDAQ, which if fully exercised, would decrease NASD's ownership to 59.9%.

Phase I of the Restructuring consisted of three separate transactions: (1) NASD sold 0.3 million NASD-owned common shares of NASDAQ at $11.00 per share generating net proceeds of $3.5 million and recorded a gain of $2.3 million; (2) NASD sold 6.4 million warrants to purchase an aggregate of 25.7 million NASD-owned common shares of NASDAQ at $11.00 per warrant generating net proceeds to NASD of $68.7 million; and (3) NASDAQ sold 23.7 million newly issued common shares at $11.00 per share generating net proceeds to NASDAQ of $253.3 million. NASD has received a ruling from the Internal Revenue Service ("IRS") stating that the sale of NASDAQ shares and warrants will not result in taxable income to NASD.

Phase II of the Restructuring closed on January 18, 2001, yielding net proceeds to NASD and NASDAQ of $113.4 million and $63.7 million, respectively. Phase II of the Restructuring also consisted of three separate transactions: (1) NASD sold 4.2 million NASD-owned common shares of NASDAQ at $13.00 per share generating net proceeds of $53.5 million to NASD and recorded a gain of $31.4 million; (2) NASD sold 4.4 million warrants to purchase an aggregate of 17.6 million NASD-owned common shares of NASDAQ at $14.00 per warrant generating net proceeds to NASD of $59.9 million; and (3) NASDAQ sold 5.0 million newly issued common shares at $13.00 per share generating net proceeds to NASDAQ of $63.7 million. After reflecting the repurchase by NASDAQ of 18.5 million shares of its Common Stock from NASD in May 2001, at December 31, 2001, NASD owned 69.0% of NASDAQ on a non-diluted basis. Assuming the exercise or conversion of all potentially dilutive securities, NASD's ownership in NASDAQ reduces to 25.3%.

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. The first annual tranche became exercisable on June 28, 2002.

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 issued by NASD in Phase I and II. 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

(Dollars in tables in thousands)

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 their proportionate remaining ownership of NASDAQ of $154.6 million. This transaction was another element of the continuing plan of corporate reorganization with regard to NASD's investment in NASDAQ. 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.

For the year ended December 31, 2002, 20,830 warrants were exercised and 20,830 shares of Common Stock were issued from warrant exercises, yielding gross proceeds to NASD of $0.3 million. As of December 31, 2002, 43.2 million shares of Common Stock remained as underlying the outstanding warrants issued in Phases I & II.

NASD owns all of the outstanding shares of NASDAQ Series A and Series B Preferred Stock. All of the shares of NASDAQ Common Stock repurchased by NASDAQ from NASD are no longer outstanding. As of December 31, 2002, NASD's ownership in NASDAQ was 55.2%. After reflecting this repurchase of shares by NASDAQ and the assumed exercise or conversion of all potentially dilutive securities, NASD's ownership in NASDAQ reduces to 0.0%. However, as discussed in the next paragraph, until NASDAQ Exchange Registration takes place, NASD will retain voting control of NASDAQ pursuant to the terms of the Series B Preferred Stock.

The Series A Cumulative Preferred Stock carries a 7.6% annual dividend rate payable at the discretion of NASDAQ's Board of Directors. Dividends do not begin accruing until March 2003. 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 anytime 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. Series B Preferred Stock will be entitled 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 obtains 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 initial public offering, and upon the occurrence of certain other events, to redeem all or a portion of the Series A Preferred Stock.

On July 1, 2002, the Common Stock of NASDAQ began trading under the symbol "NDAQ" on the Over-the-Counter Bulletin Board. The limited trading of the security began upon the expiration of the contractual transfer restrictions imposed in connection with the sale of Common Stock by NASDAQ and NASD in Phase I and Phase II of the Restructuring that occurred in June 2000 and January 2001, respectively.

Until NASDAQ's registration as an exchange is approved by the SEC and becomes effective ("Exchange Registration"), the shares of NASDAQ Common Stock underlying unexercised and unexpired warrant tranches, as well as the shares of NASDAQ Common Stock purchased through the exercise of warrants, will be voted by a voting trustee at the direction of NASD. Upon Exchange Registration, 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 the 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, 2002, the Exchange Registration has not become effective.

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 accounts 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.

(Dollars in tables in thousands)

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 Statement of Financial Accounting Standards ("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. For the years ended December 31, 2002, and 2001, NASD recorded a charge of $33.7 million and $5.1 million, respectively, related to declines in the fair value of its investments that were judged to be other-than-temporary. These write downs are reflected in the net realized investment losses line in the consolidated statements of income.

DERIVATIVE INSTRUMENTS

On January 1, 2001, the Company adopted 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 its investment funds with outside investment managers. The Company periodically 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 or contained embedded derivatives. As of December 31, 2002, and 2001, the fair value of these derivative instruments was insignificant.

As discussed in Note 1, 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 warrants 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 determined using a Black-Scholes model with changes in the fair value being recorded to the income statement, which resulted in a gain of $104.7 million in 2002.

(Dollars in tables in thousands)

RECEIVABLES, NET

The Company's receivables are primarily concentrated with NASD members, Amex member firms, market data vendors and NASDAQ issuers. Receivables are shown net of reserves for uncollectable 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 $8.3 million and $11.1 million at December 31, 2002, and 2001, respectively.

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 collectability of amounts owed to the Company. NASD uses multiple outside fund managers to manage its investment portfolio and a single custody agent, a domestic company headquartered in New York, to hold and report on those investments. NASDAQ conducts its investment activity through a subsidiary headquartered in Delaware.

The Company is economically dependent on three suppliers to support its operations. Those suppliers provide telecommunications services and information technology services to the Company and support back office functions for Amex trading operations. To the extent that any of these suppliers are 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.

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 2002, goodwill and certain intangibles will no longer be amortized, but instead tested for impairment at least annually. Based on the impairment tests performed, there was no impairment of goodwill as of December 31, 2002. There can be no assurance that future goodwill impairment tests will not result in a charge to earnings. For the year ended December 31, 2001 goodwill and other intangible assets were amortized using the straight-line method over their estimated period of benefit, ranging from five to ten years. NASD 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, 2002, and 2001, goodwill and other intangibles were $22.2 million and $23.1 million, respectively, and are included in other assets in the consolidated balance sheets. Goodwill amortization expense was $1.6 million for the year ended December 31, 2001, and is included within depreciation and amortization expense in the consolidated statements of income. Other intangible asset amortization expense was $3.6 million and $3.1 million for the years ended December 31, 2002, and 2001, respectively, and is included within depreciation and amortization expense in the consolidated statements of income.

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 on 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 related to assets held under capital leases is included in depreciation and amortization expense in the consolidated statements of income. Depreciation and amortization expense for property and equipment totaled $149.0 million and $144.4 million for the years ended December 31, 2002, and 2001, respectively.

(Dollars in tables in thousands)

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.

During 2001, the Company recorded total impairment charges of long-lived assets (primarily related to internally developed software) totaling $7.1 million. These impairment charges were recorded in other operating expenses in the consolidated statements of income. No impairment charges were recognized in 2002.

INVESTMENTS IN AND ADVANCES TO AFFILIATES AND SUBSIDIARIES

The Company carries its various investments in affiliates at cost and under the equity method of accounting depending upon its ability to influence the operations of the affiliate. Investments in and advances to affiliates are included in other assets in the consolidated balance sheets and amount to $10.9 million and $2.7 million as of December 31, 2002, and 2001, respectively. See Note 6 for additional information on the Company's significant investments in and advances to affiliates and subsidiaries.

NET SEC FEES

NASD and Amex collect a fee based on a percentage of the total dollar value of securities sold in the NASDAQ and Amex markets. These fees are designed to cover costs incurred by the government in the supervision and regulation of securities markets and securities professionals. The Company collects these fees from its members and remits them to the United States Treasury semiannually in March and September. The liability for net SEC fees represents amounts collected from members but not yet remitted to the United States 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"). IL fees are recognized over six years and LAS fees are recognized over four years.

DEPOSITS AND RENEWALS

NASD member 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 deposits included in deposits and renewals in the consolidated balance sheets totaled $23.3 million and $24.4 million as of December 31, 2002, and 2001, respectively. CRD renewals included in deposits and renewals in the consolidated balance sheets totaled $29.3 million and $30.3 million as of December 31, 2002, and 2001, respectively.

ISSUANCE OF SUBSIDIARY STOCK

The Company recognizes gains and losses on issuances of subsidiary stock in members' equity. During 2002 and 2001, the Company recognized a gain in members' equity totaling $1.0 million and $11.2 million, respectively, related to other issuances of subsidiary stock. During 2001, the Company recognized a gain in members' equity totaling $27.8 million related to NASDAQ's issuance of new shares in connection with Phase II.

REVENUE RECOGNITION

Market information fees 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 revenue is 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 assessment fees are recognized evenly over the year to which the fee relates and are recorded net of any rebates paid to members. Initial registration fees for members are

(Dollars in tables in thousands)

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 twelve-month period. IL and LAS fees are recognized on a straight-line basis over their estimated service periods (see Note 3). Arbitration fees are recognized as cases are filed and sessions are held. Fines are recognized when the cash is received. In January 2002, NASDR censured a large investment banking NASD member firm for taking inflated commissions in what amounted to profit-sharing arrangements on Initial Public Offerings serviced by that firm. NASDR received $50.0 million in monetary sanctions, which is recorded within fines revenue in the consolidated statements of income.

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 $13.3 million and $12.8 million for 2002 and 2001, respectively.

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.

Capitalized software development costs of $153.6 million and $121.7 million as of December 31, 2002 and 2001, respectively, are carried in data processing equipment and software in the consolidated balance sheets. Amortization of costs capitalized under SOP No. 98-1 totaled $24.1 million and $13.8 million for 2002 and 2001, respectively, and are included in depreciation and amortization in the consolidated statements of income.

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.

Pro forma information regarding net income and earnings per share is required under SFAS No. 123, "Accounting for Stock-Based Compensation" and has been determined as if NASDAQ had accounted for all stock option grants based on the 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 4.31% and 4.68% for 2002 and 2001, respectively. The weighted-average fair value of options granted in 2002 and 2001 was $4.69 and $4.55, respectively.

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 net (loss) income for the years ended December 31, 2002, and December 31, 2001, was ($6.8) million and $100.8 million, respectively.

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.

(Dollars in tables in thousands)

REDUCTION IN FORCE

During 2002, the Company recorded a charge of $4.5 million for severance and outplacement costs associated with staff reduction plans. In the first quarter of 2002, a charge of $0.9 million was recorded and 34 positions were eliminated. In the fourth quarter of 2002, a charge of $3.6 million was recorded and 105 positions were eliminated.

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. Translation adjustments resulting from this process are charged or credited to other comprehensive income. Revenue and expenses are translated at average exchange rates during the year. Gains and losses on foreign currency transactions are included in other expenses. 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.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 requires that a liability for costs associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. SFAS No. 146 is effective for exit or disposal activities that are initiated after December 31, 2002. The Company does not expect the adoption of SFAS No. 146 to have a material impact on the financial statements.

In November 2002, the FASB issued FASB Interpretation ("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. The Company does not expect the adoption of FIN No. 45 to have a material impact on the financial statements.

In January 2003, the FASB issued FIN No. 46 "Consolidation of Variable Interest Equities." FIN No. 46 addresses consolidation by business enterprises of variable interest entities ("VIEs"). The accounting provisions and disclosure requirements of FIN No. 46 are effective immediately for VIEs created after January 31, 2003, and are effective for reporting periods beginning after June 15, 2003, for VIEs created prior to February 1, 2003. The Company does not expect the adoption of FIN No. 46 to have a material impact on the financial statements as the Company currently does not have any investments in VIEs.

RECLASSIFICATIONS

Certain amounts for the prior year have been reclassified to conform to the 2002 presentation.

(Dollars in tables in thousands)

3. DEFERRED REVENUE

The Company accounts for issuer service revenues in accordance with Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition in Financial Statements." 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.

The Company recognized a one-time cumulative effect of a change in accounting principle as of January 1, 2000. For the years ended December 31, 2002, and 2001, the Company recognized an aggregate of $31.6 million and $44.9 million, respectively, in revenue that was deferred as part of the cumulative effect adjustment as of January 1, 2000. This revenue contributed $19.2 million (after income taxes of $12.4 million) and $27.3 million (after income taxes of $17.6 million) to net income for the years ended December 31, 2002, and 2001, respectively.

Following is a summary of amounts included in the Company's current and non-current deferred revenue as of December 31, 2002, relating to IL and LAS fees, and the years over which those amounts will be recognized:

	IL FEES	LAS FEES	TOTAL FEES
2003	$ 30,993	$ 33,640	$ 64,633
2004	26,267	23,098	49,365
2005	19,962	13,213	33,175
2006	9,777	2,855	12,632
2007 and thereafter	6,858	35	6,893
Total	$ 93,857	$ 72,841	$ 166,698

Following is a summary of activity in the Company's current and non-current deferred revenue for the years ended December 31, 2002, and 2001 relating to IL and LAS fees. 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 FEES	LAS FEES	TOTAL FEES
Balance as of January 1, 2002	**$ 104,629**	**$ 82,424**	**$ 187,053**
Additions	**22,840**	**27,948**	**50,788**
Amortization	**(33,612)**	**(37,531)**	**(71,143)**
Balance as of December 31, 2002	**$ 93,857**	**$ $72,841**	**$ 166,698**

	IL FEES	LAS FEES	TOTAL FEES
Balance as of January 1, 2001	$ 127,693	$ 76,651	$ 204,344
Additions	12,602	41,637	54,239
Amortization	(35,666)	(35,864)	(71,530)
Balance as of December 31, 2001	$ 104,629	$ 82,424	$ 187,053

The remainder of issuer service fees recognized as revenues in the current period primarily relates to issuer annual listing service fees charged by NASDAQ to listed companies.

(Dollars in tables in thousands)

4. INVESTMENTS

Investments principally consist of U.S. Treasury securities, obligations of U.S. Government agencies, 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, 2002:

	AMORTIZED COST	GROSS UNREALIZED GAIN	GROSS UNREALIZED LOSS	FAIR VALUE
U.S. Treasury securities and obligations of U.S. government agencies	**$ 253,954**	**$ 6,057**	**$ 185**	**$ 259,826**
Obligations of states and political subdivisions	**12,726**	**128**	**–**	**12,854**
Debt securities issued by foreign governments	**4,683**	**278**	**–**	**4,961**
Asset-backed securities	**182,269**	**2,063**	**566**	**183,766**
U.S. corporate debt securities	**271,796**	**8,154**	**1,526**	**278,424**
Other debt securities	**45,558**	**2,301**	**3,297**	**44,562**
Total debt securities	**770,986**	**18,981**	**5,574**	**784,393**
Mutual funds	**156,708**	**1,008**	**740**	**156,976**
Equity securities	**159,536**	**5,925**	**14,806**	**150,655**
Total	**$ 1,087,230**	**$ 25,914**	**$ 21,120**	**$ 1,092,024**

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, 2002, all held-to-maturity investments were U.S. Treasury securities and obligations of U.S. Government agencies. The securities had an amortized cost of $28.4 million and had gross unrealized gains of $0.6 million. Total estimated fair value of these held-to-maturity investments was $29.0 million at December 31, 2002. All investments classified as held-to-maturity mature in 2003 and 2004 in the amounts of $18.7 million and $9.7 million, respectively.

Following is a summary of investments classified as available-for-sale, which are carried at fair value as of December 31, 2001:

	AMORTIZED COST	GROSS UNREALIZED GAIN	GROSS UNREALIZED LOSS	FAIR VALUE
U.S. Treasury securities and obligations of U.S. government agencies	$ 252,721	$ 2,192	$ 1,230	$ 253,683
Obligations of states and political subdivisions	46,142	825	61	46,906
Debt securities issued by foreign governments	3,489	52	–	3,541
Asset-backed securities	46,581	208	145	46,644
U.S. corporate debt securities	110,427	595	1,300	109,722
Other debt securities	25,333	411	469	25,275
Total debt securities	484,693	4,283	3,205	485,771
Mutual funds	92,508	14	3,609	88,913
Equity securities	171,569	7,968	10,449	169,088
Total	$ 748,770	$ 12,265	$ 17,263	$ 743,772

As of December 31, 2001, all held-to-maturity investments were U.S. Treasury securities and obligations of U.S. Government agencies. The securities had an amortized cost of $28.6 million and had gross unrealized gains and losses of $570 thousand and $31 thousand, respectively. Total estimated fair value of these held-to-maturity investments was $29.1 million at December 31, 2001.

(Dollars in tables in thousands)

Following is a summary, by contractual maturity, of investments classified as available-for-sale as of December 31, 2002:

	AMORTIZED COST	GROSS UNREALIZED GAIN	GROSS UNREALIZED LOSS	FAIR VALUE
Due in one year or less	**$ 151,397**	**$ 611**	**$ 701**	**$ 151,307**
Due after one through five years	**332,594**	**8,456**	**2,184**	**338,866**
Due after five through ten years	**108,028**	**5,313**	**885**	**112,456**
Due after ten years	**178,967**	**4,601**	**1,804**	**181,764**
Total debt securities	**770,986**	**18,981**	**5,574**	**784,393**
Mutual funds	**156,708**	**1,008**	**740**	**156,976**
Equity securities	**159,536**	**5,925**	**14,806**	**150,655**
Total	**$ 1,087,230**	**$ 25,914**	**$ 21,120**	**$ 1,092,024**

The net adjustment to unrealized gains (losses) on available-for-sale securities included as a separate component of members' equity due to the sale of securities during 2002 and 2001 totaled ($6.5) million and $3.1 million, respectively. The gross realized gains on such sales in 2002 and 2001 totaled $23.0 million and $12.2 million, respectively, and the gross realized losses totaled $38.3 million and $19.7 million, respectively.

At December 31, 2002, and 2001, investments with a carrying value of $28.4 million and $28.6 million were pledged as collateral for NASDAQ's $25.0 million note payable (see Note 8).

In connection with the OptiMark, Inc. ("OptiMark") partnership, OptiMark issued warrants to NASDAQ to purchase up to an aggregate of 11.3 million shares of its Common Stock, $.01 par value per share, which expire in 2004. The warrants are exercisable in several tranches upon the achievement of certain milestones, which are based primarily upon the average daily share volume of NASDAQ-listed securities traded through the OptiMark Trading System.

In September 2000, OptiMark announced a strategic change in its business that will allow it to focus on providing technology solutions to electronic marketplaces. As part of the change, OptiMark decided to suspend trading operations on the OptiMark Trading System. As a result, NASDAQ management concluded that its investment in warrants in OptiMark as well as the realization of the deferred revenue related to these warrants was impaired and reduced its investment in warrants and related deferred revenue to zero. As of December 31, 2002, NASDAQ still considered the investment in warrants and the related deferred revenue impaired.

5. GOODWILL AND OTHER INTANGIBLE ASSETS

At December 31, 2002, and 2001, the only goodwill recorded by NASD represented NASDAQ's goodwill of $10.1 million related to its acquisitions of NASDAQ Europe and NASDAQ Tools.

Intangible assets with finite lives continue to be amortized over their estimated useful lives. At December 31, 2002, and December 31, 2001, NASD has intangible assets of $12.1 million and $13.0 million (net of accumulated amortization of $8.5 million and $4.9 million), respectively. NASD estimates amortization expense for the years ended December 31, 2003, 2004, 2005, 2006 and 2007 to be $4.8 million, $3.8 million, $1.7 million, $0.9 million and $0.3 million, respectively.

Through December 31, 2001, goodwill was amortized over periods of five to ten years on a straight-line basis. The following table presents the impact of SFAS No. 142 on reported net income had the accounting standard been in effect for December 31, 2001:

	YEARS ENDED DECEMBER 31,	
	2002	**2001**
Net (loss) income	**$ (3,480)**	$ 111,999
Add back: goodwill amortization (net of tax of $492 and minority interest of $266)	**–**	763
Adjustment net (loss) income	**$ (3,480)**	$ 112,762

6. INVESTMENT IN AND ADVANCES TO AFFILIATES AND SUBSIDIARIES

NQLX

On June 1, 2001, NASDAQ signed an agreement with the London International Financial Futures and Options Exchange ("LIFFE") creating NQLX, a U.S. joint venture company to list and trade single stock futures. On November 8, 2002, NASDAQ launched NQLX, an electronic exchange offering a broad range of futures contracts. NQLX is an independent exchange. NASDAQ has committed up to $25.0 million plus the rights to use certain of its trademarks in this venture. NASDAQ made $2.0 million of capital contributions to the NQLX

(Dollars in tables in thousands)

joint venture in 2001. During 2002, NASDAQ made additional contributions to NQLX of $16.0 million. An additional $7.0 million is expected to be contributed in 2003, which will fulfill NASDAQ's Board's initial approval of $25.0 million. On August 21, 2001, the Commodity Futures Trading Commission approved NQLX as a futures market and self-regulatory organization and on November 8, 2002, NQLX was launched. Through the end of 2002, NQLX operated under a fee holiday during which NQLX had no revenue. This fee holiday ended on March 31, 2003. NASDAQ accounts for its investment in NQLX under the equity method of accounting. In 2002 and 2001, NASDAQ recorded losses of $9.0 million and $6.0 million, respectively representing its share of the losses incurred by NQLX.

A condensed summary of assets and liabilities and results of operations for NQLX for 2002 and 2001 follows:

	December 31, 2002	December 31, 2001
Condensed balance sheet information:		
Current assets	**$ 5,279**	$ 1,595
Non-current assets	**5,156**	3,085
Current liabilities	**4,255**	1,034
Non-current liabilities	**–**	10,287

	Years Ended December 31, 2002	Years Ended December 31, 2001
Condensed income statement information:		
Expenses	**$ 17,399**	$ 11,939
Operating loss	**(17,399)**	(11,939)
Net loss	**(17,807)**	(11,919)

NASDAQ JAPAN

In 1999, NASD contributed $2.6 million for its initial 50.0% interest in NASDAQ Japan. After granting a restricted stock award of 4.0% of its shares, NASD transferred its remaining 46.0% interest to NASDAQ Global. In October 2000, NASDAQ Japan sold an approximate 15.0% stake for $48.0 million to a group of 13 major Japanese, U.S. and European brokerages, thereby reducing NASDAQ Global's interest from 46.0% to 39.2%. As a result of the private placement, NASDAQ increased the carrying value of its investment by $7.8 million, recorded through member's equity, to reflect its adjusted share of the book value of NASDAQ Japan. In 2001, NASDAQ invested an additional $7.4 million in NASDAQ Japan, increasing its ownership to 39.7%.

During the second quarter of 2002, NASDAQ recognized an other-than-temporary impairment of its investment in NASDAQ Japan. NASDAQ recognized this impairment as a result of the depressed level of market activity in Japan, combined with 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. Accordingly, NASDAQ Japan did not have the capacity to raise capital to fund its operations beyond 2002. Thus, NASDAQ Japan's financial liabilities to NASDAQ were not expected to be repaid and were recognized as a loss.

On August 16, 2002, the Board of Directors of NASDAQ Japan voted to take the company to dormant status, effectively ceasing operations. Shareholders of NASDAQ Japan subsequently ratified this decision. After careful consideration of a range of options, NASDAQ Japan's Board concluded that under current economic circumstances there was not a profitable path forward for the company. A letter was sent to the Osaka Securities Exchange formally giving notice of termination of the Business Cooperation Agreement between the Osaka Exchange and NASDAQ Japan. NASDAQ Japan is currently in liquidation status and is expected to be completely dissolved in the second quarter of 2003. Companies listed on the NASDAQ Japan Market retained their listing on the Osaka Exchange and experienced no disruption to trading.

The net impact of the other-than-temporary impairment on the Company's pre-tax income the year ended December 31, 2002, 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 during second quarter of 2002), foreign exchange translation losses and other receivables, partially offset by a re-valuation of certain variable NASDAQ Japan stock based awards of $7.9 million.

(Dollars in tables in thousands)

Prior to the impairment loss recognized on its investment in NASDAQ Japan, NASDAQ accounted for its investment in NASDAQ Japan under the equity method of accounting. Including the impairment of $15.2 million, NASDAQ recorded losses of $18.3 million in 2002 and $11.3 million in 2001. No additional losses are expected to be recorded regarding NASDAQ Japan.

A condensed summary of assets and liabilities and results of operations for NASDAQ Japan for the six months ended June 30, 2002, and for the year ended December 31, 2001, follows:

	JUNE 30, 2002	DECEMBER 31, 2001
Condensed balance sheet information:		
Current assets	**$ 10,300**	$ 18,560
Non-current assets	**3,967**	16,940
Current liabilities	**4,384**	13,278
Non-current liabilities	**15,137**	6,065

	SIX MONTHS ENDING JUNE 30, 2002	YEAR ENDED DECEMBER 31, 2001
Condensed income statement information:		
Revenue	**$ 1,187**	$ 1,971
Expenses	**22,990**	36,525
Operating loss	**(20,995)**	(34,554)
Net loss	**(21,009)**	(35,381)

NASDAQ TOOLS

On July 31, 2002, NASDAQ Tools, which provides software products and services related to the broker/dealer industry to be used in conjunction with NASDAQ Workstation II software, was merged into NASDAQ in a statutory merger under the General Corporation Law of the State of Delaware. NASDAQ Tools was previously a wholly-owned subsidiary of NASDAQ. NASDAQ Tools now operates as a part of NASDAQ's Transaction Services business products.

On April 2, 2003, NASDAQ announced its decision to exit the Tools Plus order management business, a product of NASDAQ Tools. NASDAQ will continue to operate NASDAQ Tools for a transitional period to ensure an orderly exit. NASDAQ is currently exploring whether opportunities exist to sell the Tools Plus business.

NASDAQ DEUTSCHLAND

On October 30, 2002, NASDAQ's majority-owned subsidiary, NASDAQ Europe, and the Berlin and Bremen Stock Exchanges, as well as Comdirekt bank, Commerzbank and Dresdner Bank, signed definitive agreements dated as of October 4, 2002, to recapitalize Bremer Wertpapierbörse AG, a German stock exchange, that will be rebranded as "NASDAQ Deutschland AG" and that will be marketed under the NASDAQ brand. The recapitalization of Bremer Wertpapierbörse AG was finalized on January 21, 2003. This exchange, which will be subject to the German public law entity resulting from the merger of the Bremen Stock Exchange and the Berlin Stock Exchange, will initially be majority-owned by NASDAQ Europe. Trading in German and international blue chip, growth stocks began on March 21, 2003, and trading in German stocks began on April 7, 2003. NASDAQ has agreed to guarantee the provision of certain support and maintenance services for NASDAQ Deutschland's trading platform for a limited period in certain circumstances if NASDAQ Europe no longer provides such services (see Note 13).

NASDAQ MEMBER REVENUE SHARING

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

(Dollars in tables in thousands)

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 ("UTP") Plan based on their respective share of 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 New York Stock Exchange, Inc. ("NYSE") and Amex listed securities through NASDAQ.

NASDAQ EUROPE S.A./N.V.

On March 27, 2001, NASDAQ acquired a majority ownership interest in the European Association of Securities Dealers Automated Quotation S.A./N.V., a pan-European stock market headquartered in Brussels, for $12.5 million. NASDAQ renamed the company NASDAQ Europe S.A./N.V. ("NASDAQ Europe") as part of a plan to restructure it into a globally linked, pan-European market. NASDAQ's acquisition was accounted for under the purchase method of accounting, resulting in the initial recording of goodwill of $4.7 million.

During 2001, NASDAQ purchased an additional 2.0% ownership of NASDAQ Europe for $6.0 million and sold 1.2% of its ownership in NASDAQ Europe to a third party. Also during 2001, NASDAQ Europe sold additional shares representing a 9.0% ownership interest for $13.9 million to third party investors. In the first quarter of 2002, NASDAQ Europe sold additional shares to a third party, resulting in an increase of $0.7 million to members' equity.

In October 2002, NASDAQ Europe's strategic investors committed to convert $18.6 million or 73.8% of NASDAQ Europe's external debt to equity ($44.5 million or 87.1% including intercompany debt with NASDAQ). The conversion was formally approved by NASDAQ Europe's Board in March 2003 and is expected to close in May 2003. After the conversion is completed, NASDAQ will have a 60.3% ownership interest in NASDAQ Europe (See Note 18).

NASDAQ EUROPE PLANNING COMPANY LIMITED

In February 2000, NASD formed a joint venture, NASDAQ Europe Planning, with three partners, whereby each partner contributed $10.0 million in cash. NASDAQ Europe Planning's proposed joint venture did not occur due to a strategic decision to pursue a strategy for European expansion through the acquisition in March 2001 of a controlling interest in NASDAQ Europe rather than through NASDAQ Europe Planning. As a result, NASDAQ agreed to repurchase the ownership interests of the three other shareholders in NASDAQ Europe

Planning for $10.0 million each, thereby unwinding the joint venture. The repurchase of two of the shareholders was completed in the first quarter of 2001 for cash payments of $10.0 million each. The repurchase from the third shareholder was completed in the fourth quarter of 2001 for aggregate consideration estimated at $10.0 million, comprised of cash of $7.4 million, a warrant to purchase up to 479,648 shares of Common Stock, and 7,211 shares of NASDAQ Europe. As of December 31, 2002, and 2001, NASDAQ owned 100.0% of NASDAQ Europe Planning.

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 borrowings, and warrants to purchase NASDAQ stock from NASD to be its financial instruments. The carrying amounts reported in the balance sheets for cash and cash equivalents, receivables, investments, accounts payable and accrued expenses, due to custodial agent, short-term borrowings and warrants to purchase NASDAQ stock from NASD 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 borrowings was estimated using a discounted cash flow analysis, based on NASDAQ's assumed incremental borrowing rates for similar types of borrowing arrangements. This analysis indicates that the fair value of NASDAQ's long-term debt at December 31, 2002, and 2001 approximates its carrying amount.

8. BORROWINGS

SENIOR NOTES

On May 9, 2002, NASDAQ issued $150.0 million in aggregate principal amount of its 5.83% senior notes due 2007 (the "Senior Notes") in a private placement. The Senior Notes are unsecured, pay interest quarterly and may be redeemed by NASDAQ at any time, subject to a make-whole amount. The make-whole amount is equal to the excess of the discounted value of the remaining scheduled payments discounted at a factor equal to 50 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. The proceeds from the Senior Notes, $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 in the repurchase and for general corporate purposes. Interest expense under the agreement totaled $5.6 million for the year ended December 31, 2002.

(Dollars in tables in thousands)

On August 29, 2002, NASDAQ entered into a $150.0 million unsecured revolving-credit facility as amended, (the "Facility"). The Facility, which is syndicated to five banks, makes $150.0 million available to NASDAQ for a 364-day term. NASDAQ intends to use the Facility for general corporate purposes. The interest rate applicable to borrowings under the Facility (a) for U.S. based loans will be based on the higher of Citibank N.A.'s base rate and 0.5 percent per annum above the then current Federal Funds rate and (b) for LIBOR loans will be based on the offered rate for deposits in the U.S. dollars with a comparable maturity plus 0.36 percent per annum. The Facility provides for an annual fee of 0.09% of the $150.0 million Facility. The Facility, as amended, has various covenants customary for this type of facility that require NASDAQ, among other things, to maintain various financial ratios such as consolidated long-term debt to capitalization, minimum tangible net worth and consolidated earnings before interest, taxes and depreciation and amortization to consolidated interest expense. Noncompliance with the terms of the Facility by NASDAQ could result in the cancellation of the Facility with any amounts outstanding under the Facility becoming payable immediately. At December 31, 2002, NASDAQ had not utilized the Facility, and the entire $150.0 million of the Facility was available.

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 Lender's cost of funds rate, as defined in the agreement, plus 0.5%. Interest expensed and paid under the agreement totaled $1.9 million for each of the years ended December 31, 2002, and 2001.

NASDAQ Europe has $26.0 million and $23.5 million of notes payable outstanding with third parties as of December 31, 2002, and 2001, respectively. These notes are denominated in Euros, and $11.3 million matures in 2003 and the remaining notes mature in 2004 or within five days of default of any loan covenant. NASDAQ Europe incurs interest expense at a rate of 6.0% on $4.3 million of the notes and London Inter-Bank Offered Rate plus 1.0% on the remaining $21.7 million of the notes. Interest expensed and accrued totaled $1.1 million and $0.8 million for the years ended December 31, 2002, and 2001, respectively.

NASDAQ Europe also has $21.7 million of intercompany loans with NASDAQ outstanding as of December 31, 2002. NASDAQ funded these loans to finance the operations of NASDAQ Europe and to enable NASDAQ Europe to invest in NASDAQ Deutschland AG, a venture among NASDAQ Europe, several German banks and two regional German exchanges (see Note 13). NASDAQ has agreed to convert the intercompany loans from debt to equity if the majority of the European strategic partners also convert their debt to equity. In October 2002, NASDAQ Europe's strategic investors committed to convert $18.6 million or 73.8% of

NASDAQ Europe's external debt to equity ($44.5 million or 87.1% including intercompany debt with NASDAQ). The conversion was formally approved by NASDAQ Europe's Board in March 2003 and is expected to close in May 2003.

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 ("Hellman & Friedman"). Until NASDAQ becomes registered with the SEC as a national securities exchange ("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. NASDAQ used the proceeds from the sale of the Subordinated Notes to purchase 18.5 million shares of Common Stock from NASD for $13.00 per share. The annual 4.0% coupon will be payable in arrears and the Subordinated Notes are 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. On November 12, 2001, NASDAQ sold an aggregate amount of 500,000 shares of its Common Stock to Hellman & Friedman for an aggregate offering price of $5.1 million, which was the fair value at that date.

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, Hellman & Friedman owned an approximate 13.9% equity interest as a result of these Subordinated Notes in NASDAQ as well as 500,000 shares owned of Common Stock as of December 31, 2002. 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, serves as a director of NASDAQ pursuant to this agreement.

(Dollars in tables in thousands)

9. INCOME TAXES

The income tax provision includes the following amounts:

	Years Ended December 31, 2002	2001
Current income taxes:		
Federal	**$ 22,183**	$ 50,625
State	**5,204**	10,885
Total current income taxes	**27,387**	61,510
Deferred income taxes:		
Federal	**11,259**	(22,078)
State	**2,403**	(1,100)
Total deferred income taxes	**13,662**	(23,178)
Total provision for income taxes	**$ 41,049**	$ 38,332

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

	Years Ended December 31, 2002	2001
Federal	**35.0%**	35.0%
State	**5.9**	6.2
Foreign losses without U.S. benefit	**12.0**	15.9
Tax preferred investments	**(0.9)**	(6.9)
State temporary differences at a lower rate	**–**	1.9
Tax credit	**(2.8)**	(4.6)
Other, net	**(0.4)**	1.1
Effective rate	**48.8%**	48.6%

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, 2002	2001
Domestic	**$ 113,716**	$ 114,640
Foreign	**(29,539)**	(35,845)
Income before income tax expense and discontinued operations	**$ 84,177**	$ 78,795

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

	DECEMBER 31, 2002	2001
Total deferred tax assets	**$ 210,181**	$ 174,169
Total deferred tax liabilities	**(51,538)**	(73,045)
Net deferred tax assets, before valuation allowance	**158,643**	101,124
Valuation allowance	**(87,162)**	(29,284)
Net deferred tax assets	**$ 71,481**	$ 71,840

As of December 31, 2002, and 2001, respectively, deferred tax assets consisted primarily of book and tax differences related to deferred fees of $72.6 million and $78.3 million, foreign net operating losses of $33.3 million and $31.3 million, technology costs of $9.6 million and $11.8 million, bad debts of $9.6 million and $5.9 million, and loss carryforwards of $47.8 million and $18.7 million.

As of December 31, 2002, and 2001, respectively, deferred tax liabilities consisted primarily of book and tax differences related to software development costs of $35.9 million and $29.0 million, depreciation of $10.8 million and $10.6 million, and Amex LLC basis difference of $0.0 million and $31.1 million.

(Dollars in tables in thousands)

The increase in the valuation allowance is due to an increase in foreign net operating losses, as well as operating losses of NAHO in 2002 and the tax effect of excess losses accrued for financial reporting purposes over amounts deductible in 2002 relating to the Amex discontinued operations. The NAHO net operating losses will expire through 2022. Of the $33.3 million foreign net operating losses at December 31, 2002, $11.0 million will expire 2007 through 2009 and $22.3 million have no expiration date. In addition, on December 31, 2002, and 2001, NASDAQ has a deferred tax asset related to a deferred capital loss carryforward of $6.1 million.

10. EMPLOYEE BENEFITS

As of December 31, 2002, and 2001, the Company provided two non-contributory defined benefit pension plans and one non-contributory postretirement benefit plan 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"). The benefits are primarily based on years of service and the employees' average salary during the highest 60 consecutive months of employment. The plan assets for the ERP plan consist primarily of fixed income and equity securities.

In 2000, NASD maintained separate defined benefit pension plans and a separate postretirement benefit plan for employees of its Amex subsidiary from those maintained for employees of all of its other majority-owned subsidiaries.

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

	Pension Benefits 2002	Pension Benefits 2001	Other Postretirement Benefits 2002	Other Postretirement Benefits 2001
CHANGE IN BENEFIT OBLIGATION				
Benefit obligation at beginning of year	**$ 159,189**	$ 143,235	**$ 801**	$ –
Service cost	**17,744**	15,747	**52**	43
Interest cost	**11,830**	10,432	**55**	51
Amendments	**1,587**	1,659	**–**	–
Actuarial losses	**12,321**	(2,724)	**(50)**	–
Benefits paid	**(22,794)**	(11,877)	**–**	(17)
Curtailment/settlement gain	**–**	(1,301)	**–**	–
Loss due to change in discount rate	**14,870**	4,320	**82**	35
Other benefits/changes	**987**	(302)	**–**	689
Benefit obligation at end of year	**$ 195,734**	$ 159,189	**$ 940**	$ 801
CHANGE IN PLAN ASSETS				
Fair value of plan assets at beginning of year	**$ 102,247**	$ 100,743	**$ –**	$ –
Transfers between related parties	**960**	(462)	**–**	–
Actual return on plan assets	**(12,708)**	2,210	**–**	–
Company contributions	**23,290**	11,633	**–**	17
Participant contributions	**–**	–	**–**	–
Benefits paid	**(22,794)**	(11,877)	**–**	(17)
Fair value of plan assets at end of year	**90,995**	102,247	**–**	–
Funded status of the plan (underfunded)	**(104,739)**	(56,942)	**$ (940)**	$ (801)
Unrecognized net actuarial loss	**62,373**	15,580	**64**	35
Unrecognized prior service cost	**3,829**	3,258	**–**	–
Unrecognized transition obligation/(asset)	**(1,038)**	(1,252)	**613**	651
Amount recognized to reflect minimum liability	**(4,341)**	(3,425)	**–**	–
Net accrued benefit cost recorded in the consolidated balance sheets	**$ (43,916)**	$ (42,781)	**$ (263)**	$ (115)

(Dollars in tables in thousands)

The net accrued pension cost as of December 31, 2002, as reflected above, consists of the accrued benefit cost from the underfunded ERP plans and the unfunded SERP.

The components of the accrued benefit cost for the Company's defined benefit pension plans as of December 31, 2002, and 2001 along with the location of these amounts in the consolidated balance sheets were as follows:

	DECEMBER 31, 2002	2001
ERP – included in accrued personnel costs	**$ (10,989)**	$ (4,344)
ERP – included in accrued pension and other postretirement benefit costs	**(19,125)**	(20,292)
SERP – included in accrued pension and other postretirement benefit costs	**(13,802)**	(18,145)
Accrued benefit costs	**$ (43,916)**	$ (42,781)

As of December 31, 2002 and 2001, the following is the funded status of each of NASD's defined benefit pension plans:

	DECEMBER 31, 2002	2001
ERP		
Projected benefit obligations	**$ 178,594**	$ 136,561
Accumulated benefit obligations	**100,885**	78,182
Fair value of plan assets	**90,995**	102,247
SERP		
Projected benefit obligations	**$ 17,140**	$ 22,628
Accumulated benefit obligations	**13,742**	17,600
Fair value of plan assets	**–**	–

During 2002, there was a settlement of $1.2 million for employees included within the SERP plan due to early retirements. During 2001, there was a curtailment gain recognized of $1.3 million in the pension plan to reflect the reduction in force on June 26, 2001.

Pursuant to the provisions of SFAS No. 87 "Employer's Accounting for Pensions," related to the SERP, an intangible asset of $1.3 million and $1.0 million, and a net adjustment to members' equity of $3.1 million and $1.0 million, were recorded as of December 31, 2002, and 2001, 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		OTHER POSTRETIREMENT BENEFITS	
	2002	2001	2002	2001
WEIGHTED-AVERAGE ASSUMPTIONS AS OF DECEMBER 31:				
Discount rate	**6.75%**	7.25%	**6.75%**	7.25%
Expected return on plan assets	**9.0**	9.0	**–**	–
Rate of increase (compensation or health care cost)	**5.5**	5.3	**5.5**	5.5

	PENSION BENEFITS		OTHER POSTRETIREMENT BENEFITS	
	2002	2001	2002	2001
COMPONENTS OF NET PERIODIC BENEFIT COST, YEARS ENDED DECEMBER 31:				
Service cost	**$ 17,744**	$ 15,747	**$ 52**	$ 43
Interest cost	**11,830**	10,432	**55**	51
Expected return on plan assets	**(9,025)**	(8,629)	**–**	–
Amortization of unrecognized transition asset	**(215)**	(215)	**38**	38
Recognized net actuarial (gains) losses	**(57)**	61	**–**	–
Prior service cost (income) recognized	**947**	698	**–**	–
Curtailment/settlement loss (gain) recognized	**3,523**	16	**–**	–
Other benefits/changes	**–**	760	**–**	–
Benefit cost (income)	**$ 24,747**	$ 18,870	**$ 145**	$ 132

(Dollars in tables in thousands)

The assumptions for the annual increase in the composite health care cost trend rate are 7.5% and 8% for 2002 and 2001. The health care cost trend rate for 2002 was assumed to decrease gradually to an estimated annual increase of 5% in the year 2007 and thereafter. The assumed health care cost trend rate can have a significant effect on the amounts reported. A one-percentage point change in the assumed health care cost trend rate would not have a material impact on the benefit obligation, service costs and interest components.

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 2002 and 2001 was $9.0 million and $11.7 million, respectively. The expense included a discretionary match totaling $2.1 million for 2002 and $2.6 million for 2001.

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 24.5 million shares are authorized under the Plan. At December 31, 2002, 13.0 million shares were available for future grants under the Plan.

In 2002, NASDAQ granted 2.2 million stock options and 77 thousand shares of restricted stock to employees and officers and 65 thousand options to non-employee Board of Directors members pursuant to the Plan. During 2002, 0.9 million stock options and 49 thousand shares of restricted stock awards were forfeited.

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 and $4.1 million in amortization expense related to restricted stock during the years ended December 31, 2002, and December 31, 2001, respectively.

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, 2002, options for 5.3 million shares were vested, and exercisable with a weighted-average exercise price of $12.77. At December 31, 2001, options for 3.6 million shares were vested, and exercisable with a weighted-average exercise price of $12.73.

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

Stock option activity during the year ended December 31, 2001 is set forth below:

		PRICE PER SHARE	
	SHARES	RANGE	WEIGHTED AVERAGE
Balance, January 1, 2001	–	–	–
Granted	10,795,223	$ 10.25–13.00	$ 12.73
Exercised	–	–	–
Forfeited	1,169,636	$ 10.25–13.00	$ 12.98
Balance, December 31, 2001	9,625,587	$ 10.25–13.00	$ 12.70

(Dollars in tables in thousands)

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 2002 and 2001, employees purchased an aggregate of 0.2 million and 0.3 million shares at a weighted-average price of $10.22 and $10.63 per share, respectively.

In May and July 2000, restricted Common Stock and options on Common Stock of NASDAQ Japan were awarded to certain NASDAQ officers and key employees who devote substantial time to the operations of NASDAQ Japan. These awards contained restrictions and were subject to vesting provisions, generally three years. The options were granted at an exercise price of $125 per share, the estimated fair market value of the Common Stock at the time of the award. The options were exercisable for a period of seven years. As of December 31, 2001 there were 784 stock options outstanding to purchase shares of NASDAQ Japan held by NASDAQ Global, 261 of them exercisable with an approximate value of $6,175 per share. The restricted Common Stock award was for 1,900 shares at the estimated fair value of $125 per share. Approximately one-third of the shares vested immediately while the remaining two-thirds were to vest over a two-year period. As of December 31, 2001, the restricted Common Stock had an approximate value of $6,250 per share. All share and dollar amounts reflect a four-for-one stock split of NASDAQ Japan shares in April 2001.

The options and restricted Common Stock awards were marked to market, and the fair value was being expensed over the vesting periods. NASDAQ recorded $2.8 million in compensation expense related to these awards in 2001. During the second quarter of 2002, NASDAQ recognized a $15.2 million other-than-temporary impairment of its investment in NASDAQ Japan. Included in this impairment charge was a benefit for the revaluation of the stock based awards of $7.9 million. As of December 31, 2002, the options outstanding have no value and effectively were cancelled. On August 16, 2002, the Board of Directors of NASDAQ Japan voted to take the company to dormant status, effectively ceasing operations. NASDAQ Japan is currently in liquidation status and is expected to be completely dissolved in the second quarter of 2003 (see Note 6).

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 $37.9 million in 2002 and $39.4 million in 2001.

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, 2002:

Year ending December 31,		
2003	$	33,020
2004		34,731
2005		33,355
2006		32,244
2007		29,538
Remaining years		282,031
Total minimum lease payments	$	444,919

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, 2002:

Year ending December 31,		
2003	$	5,222
2004		5,222
2005		3,048
		13,492
Less: imputed interest		(1,361)
Total minimum lease payments	$	12,131

(Dollars in tables in thousands)

13. COMMITMENTS AND CONTINGENCIES

NASDAQ entered into a six-year $600.0 million contract with WorldCom 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 WorldCom of $300.0 million. 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 WorldCom 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. Although WorldCom declared bankruptcy in July 2002, NASDAQ does not foresee any interruption in service under the contract.

As of December 31, 2002, €21.3 million ($22.3 million) was funded in the form of a loan from a commitment of €31.8 million ($33.4 million) for NASDAQ Europe. Of the funded amount, €15.5 million ($16.2 million) was used to finance the operations of NASDAQ Europe through 2002. The remaining €5.8 million ($6.1 million) was used to enable NASDAQ Europe to invest in NASDAQ Deutschland AG, a venture among NASDAQ Europe, several German banks and two regional German exchanges. NASDAQ has agreed to convert the aggregate amount of outstanding loans from debt to equity if the majority of the European strategic partners also convert their debt to equity. In October 2002, NASDAQ Europe's strategic investors committed to convert 73.8% of NASDAQ Europe's external debt to equity (or 87.1% including intercompany debt with NASDAQ). The conversion was formally approved by NASDAQ Europe's Board in March 2003 and is expected to close in May 2003. An additional €10.5 million ($11.1 million) is expected to be contributed in 2003 for NASDAQ Europe operations, which will fulfill NASDAQ's Boards funding approval of €31.8 million ($33.4 million).

NASDAQ has agreed to guarantee the provision of certain support and maintenance services for the trading platform to be operated by NASDAQ Deutschland AG in the event NASDAQ Europe no longer provides such services due to circumstances including its liquidation or winding down. NASDAQ's obligation to provide services would continue for a period of 18 months from the date the guarantee is triggered, but in no event longer than three years from the date trading begins on the NASDAQ Deutschland exchange. NASDAQ will be obligated to perform under the guarantee only if NASDAQ Deutschland satisfies certain conditions, including minimum quarterly order flow requirements for periods starting in the fourth quarter of 2003. NASDAQ estimates the maximum cost of providing the services at €14.7 million ($15.4 million) over the term of the guarantee.

The Board of Director's of NASDAQ have approved a capital contribution of up to $25.0 million to the NQLX joint venture. NASDAQ made a $2.0 million capital contribution in 2001. During 2002, NASDAQ made additional contributions to NQLX of $16.0 million. An additional $7.0 million is expected to be contributed in 2003, which will fulfill NASDAQ's Board's initial approval of $25.0 million.

From the $72.2 million in net proceeds NASD received for the sale of warrants and shares of NASDAQ Common Stock in Phase I, NASD established a $25.0 million earmark for the benefit of Amex to support Amex business operations and meet NASD's obligations to Amex arising out of its acquisition of Amex. In October 2000, NASD funded this $25.0 million to Amex in the form of a capital contribution. Additionally, from the Phase I proceeds, NASD established a $25.0 million earmark for the benefit of NASDR to fund membership fee reductions. Member rebates given to NASD members were $24.0 and $17.0 in 2002 and 2001, respectively. Future cumulative fee reductions are expected to be $90.0 million through 2006. NASD established additional earmarks of $25.0 million each to Amex and NASDR from the $113.4 million in net proceeds from Phase II. In May 2001, NASD funded $15.0 million under the Amex earmark in the form of a capital contribution. Additionally, NASD may also establish additional earmarks from the proceeds received upon exercise of the warrants.

On June 1, 1999, NASD finalized a ten-year agreement with EDS Corporation (the "EDS Agreement") to establish an alliance, NasTech, through which EDS provides technology services to NASD and NASDR. NASD has 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 will be prorated through the ending date of the EDS Agreement on May 31, 2009. Included in the total minimum obligation, NASD is required to acquire at least $21.5 million in applications development services from EDS, and use EDS for all their production service and application maintenance needs. Additionally, in the event that NASD terminates the EDS Agreement for convenience, it is subject to a termination fee to EDS. The termination fee is based upon a formula, which considers total EDS billings and profit through the date of termination and remaining minimum payments after the date of termination. If the EDS Agreement was terminated effective December 31, 2002, NASD would have been obligated to pay EDS a termination fee estimated at $81.3 million. NASD has recorded advances to EDS of $34.3 million and $28.6 million as of December 31, 2002, and 2001, respectively, which is included in other assets in the consolidated balance sheet, which will be used to satisfy obligations under the EDS Agreement during the years ended December 31, 2005 through 2009.

(Dollars in tables in thousands)

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 2002 and 2001, the Company recognized benefits of $1.1 million and $1.1 million, respectively, in real estate tax abatement and $0.3 million and $1.2 million, respectively, in sales tax abatement under this agreement.

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

During the fourth quarter of 2001, as a result of the terrorist attacks on September 11, 2001, NASDAQ decided to relocate its New York City headquarters from One Liberty Plaza, which was adjacent to the site where the World Trade Center Towers stood, to a location closer to its Times Square MarketSite Building. As of December 31, 2001, NASDAQ was obligated under the terms of its One Liberty Plaza lease to pay $106.9 million over the remaining life of the lease and recorded an estimated loss on the sublease of $21.5 million, which was included in other expense in the consolidated statements of income.

NASDAQ signed a lease commencing May 1, 2002, at 1500 Broadway, directly across from the MarketSite building and began marketing the space at its One Liberty Plaza location. Due to the softening of the real estate market in lower Manhattan, NASDAQ reconsidered its decision to relocate to 1500 Broadway and decided to support the downtown Manhattan community and maintain its headquarters at One Liberty Plaza. As a result of the decision to remain at One Liberty Plaza, NASDAQ has reevaluated the loss recorded in 2001 for One Liberty Plaza as well as its original plans to move to 1500 Broadway. 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. At December 31, 2002, the estimated loss on the sublease (including interest accretion) is $23.2 million including leasehold improvements, which is included in other expense in the consolidated statements of income. The estimated loss was calculated using an 8.0% net discount rate and an estimated 22-year sublease commencing December 2003 at estimated market rates. NASDAQ will continue to evaluate its estimated loss on 1500 Broadway.

15. DISCONTINUED OPERATIONS

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 and in December 2001, NASD and Amex's Boards appointed a committee composed of members of each Board to advise the Boards regarding separation. During 2002, NASD engaged an investment banker to assist with the various alternatives related to the separation of Amex. Significant progress on the Amex separation was made during 2002 and as of December 31, 2002, Amex met the requirements under the provisions of SFAS No. 144 to be reported as a discontinued operation. Management believes it's probable 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.

At December 31, 2002, the assets and liabilities of Amex 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, "Disclosure about Segments of an Enterprise and Related Information." Total revenues for Amex for the years ended December 31, 2002, and 2001 was $252.5 million and $281.1 million, respectively. Including intercompany expenses, Amex's net loss for the years ended December 31, 2002, and 2001 was ($4.3) million and ($2.6) million.

For the years ended December 31, 2002, and 2001, NASD recorded a net (loss) income from discontinued operations of ($121.2) million and $12.0 million, respectively. Included in the net (loss) income from discontinued operations are net income, after income taxes and excluding intercompany expenses, associated with Amex of $13.4 million and $12.0 million, for the years ended December 31, 2002, and 2001, respectively, and an estimated loss at disposal recorded as of December 31, 2002, of $134.6 million (net of tax benefit of $8.8 million). The estimated loss at disposal was calculated as the adjustment of carrying value to estimated fair value less costs to sell and includes amounts expected to be funded to Amex by NASD to settle certain remaining commitments and contingencies, an estimate of minimum working capital requirements, employee and severance costs, and liabilities to be assumed by NASD. The commitments and contingencies include the remaining obligation under the Member Equity Program discussed below, and the technology transfer agreement included within the Master Agreement (see Note 17).

In addition, the following commitments and contingencies exist with respect to Amex.

(Dollars in tables in thousands)

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.

Under the Program, an elected Seat Committee monitors the effectiveness of the Program at 18 months and 60 months from the acquisition date. At the time of the reviews, the Seat Committee determines, subject to a majority vote of the Amex members, the disbursement of portions of the initial commitment amount in one of the following ways: to owners of membership interests in Amex; as a reduction of Amex Exchange fees; and/or for investments in technology. Additionally, the Seat Committee may elect a rollover option under which it would not disburse funds until the next review date. After five years, the undistributed amount will be eligible for distribution to the Amex Members, reduction of Amex fees or investments in technology as determined by a membership vote. Every two years after that, the remainder will be eligible for distribution in the same manner until the commitment has been fully paid. The commitment will be funded from operations of NASD.

At the time of the 18-month review in June 2000, the Seat Committee recommended, and the members approved a disbursement of $15.0 million to the Amex membership. This $15.0 million distribution was funded by a capital contribution from NASD to Amex with Amex making the subsequent payments to the Amex membership. As of December 31, 2002, ten seats were purchased by NASD under the Program or a total of $2.1 million. Accordingly, as of December 31, 2002, $22.9 million remains outstanding under this commitment plus accrued interest of $6.4 million. As of December 31, 2002, NASD accrued for their remaining obligation under this agreement, which is included within (loss) income from discontinued operations in the consolidated financial statements.

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 2002 and 2001 under the Member Supplement Fund formula.

At December 31, 2002, the rights to trade on Amex LLC were embodied through The American Stock Exchange, Inc. ("Amex Corp") in the 864 memberships (the "Members"). In accordance with the Limited Liability Company Agreement of Amex LLC, in the event of liquidation of Amex LLC, Amex Corp. will satisfy all obligations of the company and distribute any remaining cash as follows: (1) each existing regular member shall receive an equal distribution up to $26 thousand; (2) each options principal member shall then receive an equal distribution up to $15 thousand; (3) the remainder shall then be distributed in a manner such that each regular member will receive from such remaining assets two times the amount distributed to each options principal member. The total amount to be distributed to the 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. 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. That decision is currently on appeal.

SIAC, an affiliated company, 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 $145.8 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 ($35.0 million, or 24%, at December 31, 2002) 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 New York State Urban Development Corporation d/b/a Empire State Development Corporation ("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. As of and for the year ended December 31, 2002,

(Dollars in tables in thousands)

Amex recorded $2.3 million as a deferred liability associated with this agreement and recognized $0.8 million as a reduction to compensation expense since it met the annual requirements under the grant as of the balance sheet date. No accrual has been recorded for relocation related penalties, since management believes the risk of such relocation is remote.

16. BUSINESS SEGMENT INFORMATION

In accordance with SFAS No. 131, NASD manages two primary business segments: NASDAQ and NASD. As described in the summary of significant accounting policies, NASDAQ represents a separate identifiable organization. NASD includes NASD, NASDR, and NASD DR.

SEGMENT INCOME OR LOSS

NASD's accounting policies for segments are the same as those described in the summary of significant accounting policies. Management evaluates segment performance based on net operating income. Prior year segment information has been restated to conform to the current composition of reportable segments. Transfers between segments are accounted for at cost.

	2002				
	NASDAQ	NASD	DISCONTINUED OPERATIONS	CONSOLIDATING ADJUSTMENTS	CONSOLIDATED
Revenues, principally from external customers	**$ 799,343**	**$ 446,587**	**$ –**	**$ (8,458)**	**$ 1,237,472**
Total operating expenses	**707,667**	**430,752**	**–**	**10,048**	**1,148,467**
Net operating income (loss)	**91,676**	**15,835**	**–**	**(18,506)**	**89,005**
Total assets	**1,175,914**	**1,652,987**	**174,206**	**(261,163)**	**2,741,944**
Long lived assets	**361,225**	**177,513**	**–**	**–**	**538,738**
Depreciation & amortization	**$ 97,911**	**$ 54,726**	**$ –**	**$ (60)**	**$ 152,577**

	2001				
	NASDAQ	NASD	DISCONTINUED OPERATIONS	CONSOLIDATING ADJUSTMENTS	CONSOLIDATED
Revenues, principally from external customers	$ 859,884	$ 409,431	$ –	$ (2,317)	$ 1,266,998
Total operating expenses	781,486	383,053	–	11,973	1,176,512
Net operating income (loss)	78,398	26,378	–	(14,290)	90,486
Total assets	1,327,630	1,596,752	269,900	(543,538)	2,650,744
Long lived assets	380,213	216,095	–	–	596,308
Depreciation & amortization	$ 93,400	$ 55,721	$ –	$ –	$ 149,121

17. PARENT COMPANY ONLY STATEMENTS – CONDENSED

The following condensed consolidated balance sheets, statements of income and statements of cash flows as of and for the years ended December 31, 2002, and 2001 present the information for the entities that Company management consider to be the parent company for NASD. This information includes: 1) the consolidated information for NASD, NASDR and NASD DR (the "Parent Entities"), and 2) NASD's investments in its NASDAQ and Amex subsidiaries (not consolidated). As disclosed in Note 1, NASD is in the process of a Restructuring relating to its ownership interests in NASDAQ, which upon completion will reduce NASD's ownership of NASDAQ to 0%. In addition, NASD has reached an agreement with the Amex Board of Directors on the ultimate separation of Amex from NASD. Accordingly, the following presentation of "Parent Company Only Statements" reflects the financial position, results of operations and cash flow for the Parent Entities, assuming deconsolidation of its NASDAQ and Amex subsidiaries.

(Dollars in tables in thousands)

	December 31, 2002	December 31, 2001
BALANCE SHEETS:		
ASSETS		
Cash and cash equivalents	**$ 269,566**	$ 267,477
Investments, available-for-sale	**869,899**	515,744
Receivables, net	**27,645**	22,315
Receivable from related parties	**35,273**	47,392
Other current assets	**11,450**	11,689
Total current assets	**1,213,833**	864,617
Total property and equipment, net	**177,513**	216,095
Investment in NASDAQ	**209,398**	357,170
Net assets– discontinued operations	**–**	102,349
Other assets	**52,243**	56,521
Total assets	**$ 1,652,987**	$ 1,596,752
LIABILITIES AND MEMBERS' EQUITY		
Payable to related parties	**$ 6,866**	$ 35,340
Net liabilities– discontinued operations	**7,407**	–
Current liabilities	**410,593**	311,853
Other liabilities	**53,565**	207,525
Total liabilities	**478,431**	554,718
Members' equity	**1,174,556**	1,042,034
Total liabilities and members' equity	**$ 1,652,987**	$ 1,596,752

STATEMENTS OF INCOME:

	Years Ended December 31, 2002	2001
REVENUES:		
Revenues, net of member rebates of $24,000 in 2002 and $17,000 in 2001	**$ 446,587**	$ 409,431
EXPENSES:		
Compensation and benefits	**233,962**	223,555
Professional and contract services	**134,118**	135,133
Depreciation and amortization	**54,726**	55,721
Other, including support charge allocated to related parties	**7,946**	(31,356)
Total operating expenses	**430,752**	383,053
Net operating income	**15,835**	26,378
OTHER INCOME (EXPENSE):		
Equity in earnings of NASDAQ	**25,927**	30,159
Other (expense) income	**(28,703)**	12,007
Gain on NASDAQ warrants	**104,667**	–
(Loss) income from discontinued operations	**(121,206)**	12,010
Gain from NASDAQ shares sold by NASD	**–**	31,445
Net (loss) income	**$ (3,480)**	$ 111,999

STATEMENTS OF CASH FLOWS:

	Years Ended December 31, 2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES	**$ 203,638**	$ 120,905
CASH FLOWS FROM INVESTING ACTIVITIES	**(129,264)**	65,824
CASH FLOWS FROM FINANCING ACTIVITIES	**(72,285)**	(148,999)
Increase in cash and cash equivalents	**2,089**	37,730
Cash and cash equivalents at beginning of year	**267,477**	229,747
CASH AND CASH EQUIVALENTS AT END OF YEAR	**$ 269,566**	$ 267,477

(Dollars in tables in thousands)

During 2002 and 2001, the repurchases by NASDAQ of NASDAQ stock held by NASD with gross proceeds of $439.0 million and $240.0 million resulted in NASD realizing proceeds in excess of its basis in the underlying shares of NASDAQ of $277.5 million and $134.4 million, respectively. As a result of these reductions in NASDAQ equity resulting from this transaction, NASD realized a reduction in it's proportionate remaining ownership of NASDAQ of $154.6 million and $93.9 million, respectively. Accordingly, the net effect of this transaction is reflected as a $122.9 million and $40.5 million increase to NASD equity in the consolidated statements of changes in members' equity for the years ending December 31, 2002, and 2001, respectively. These transactions represent another element of the continuing plan of corporate reorganization with regard to NASD's investment in NASDAQ.

RELATED PARTY TRANSACTIONS

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 have 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. In 2002 and 2001, Amex incurred $4.3 million and $3.8 million, respectively, of costs under this agreement, for which Amex was reimbursed $7.4 million from NASD in 2002 in the form of a capital contribution. The Technology Steering Committee consists of one representative each from NASD, NASDAQ and Amex and was established to supervise the performance of the Parties pursuant to the technology transition. NASD and NASDAQ expect to fund this commitment up to its $29.0 maximum, at the cost of $14.5 million each. As of December 31, 2002, NASD accrued for their remaining obligation under this agreement, which is included within (loss) income from discontinued operations in the consolidated statement of income.

Beginning in 2002, Amex began paying NASDAQ an annual fee for the right to list, trade and market the NASDAQ-100 Index Tracking Stock, otherwise known as QQQ. For the year ended December 31, 2002, this fee was $2.0 million.

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 NASDAQ paid to NASD 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.

In June 2002, NASD granted Amex a $50.0 million revolving line of credit. Interest on this line of credit is LIBOR plus .45%. The line of credit agreement matures on April 30, 2004. As of December 31, 2002, NASD had an outstanding receivable from Amex under this agreement of $50.0 million.

In December 2002, NASD sold its 50.0% interest in the NASD Insurance Agency, LLC (subsequently renamed the NASDAQ Insurance Agency, LLC ("NIA")) to NASDAQ for an initial payment of $0.5 million and up to $5.1 million based on the NASD Insurance Agency's stream of contingent cash flow through 2011. 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 NASDAQ has paid NASD the full cumulative amount of $5.1 million from cash flows. Pursuant to this transaction, NASD recognized a net increase in equity of $0.2 million related to the minority partner's share of this payment from NASDAQ.

(Dollars in tables in thousands)

18. SUBSEQUENT EVENTS

In January 2003, NASDR censured a large investment banking NASD member 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" initial public offerings ("IPO") in 1999 and 2000 during the height of the IPO boom. On January 15, 2003, the $14.0 million was received by NASDR and recorded as fines revenue in 2003.

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 it's production service needs. Furthermore, NASD cannot terminate the 2003 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 will be deferred and amortized into income over the term of the new agreement.

On May 30, 2003, NASD agreed in principle to sell its interest in Amex to a Chicago-based private equity firm, GTCR Golder Rauner LLC. The terms of this specific agreement are subject to the completion of definitive sale documents and approvals by NASD's Board of Governors, Amex's Board of Governors, Amex membership, and the Securities and Exchange Commission ("SEC").

On June 26, 2003, the SEC notified Amex that it had commenced a formal investigation into certain issues arising from an inspection of its regulatory programs by the SEC's Office of Compliance Inspections and Examinations ("OCIE") related to customer options order handling. As part of the investigation, the SEC has asked Amex to provide information relating to this matter. Amex is cooperating fully with the SEC's requests. At this time Amex cannot predict the outcome of this investigation and whether such outcome will have a material financial statement impact.

On June 26, 2003, NASDAQ announced several strategic initiatives with the ultimate intent to focus on its U.S. operations. The most significant initiative is the decision to close the market operated by NASDAQ Europe. The final plans on winding down this operation along with the calculation of the costs to complete an orderly wind down is currently in process.


A PEOPLE-FOCUSED,
PERFORMANCE DRIVEN ORGANIZATION
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