



Securities Industry Association

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December 9, 2002

By Hand and Via Electronic Mail

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File Nos. SR-NASD-2002-147 and SR-NASD-2002-148

Dear Mr. Katz:

The Securities Industry Association (“SIA”)¹ appreciates the opportunity to comment on the National Association of Securities Dealer’s (“NASD”) above-referenced rule filings.² SR-NASD-2002-147 establishes a sunset provision that terminates on December 31, 2002 for the recently-adopted Trading Activity Fee (“TAF”), which replaced the long-standing regulatory fee imposed under Section 8(a) of Schedule A of the NASD By-Laws.³ SR-NASD-2002-148 proposes the TAF once again with substantially the same rule language, but subjects it to a notice and comment period that runs until December 10, 2002. Unfortunately, implementation of the TAF has been complicated unnecessarily by the process by which the NASD has given notice and sought approval of this significant change, as discussed in Section I below. The current filings confuse the status of previously filed rule changes, although they do not appear to

¹ The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2001, the industry generated \$198 billion in U.S. revenue and \$358 billion in global revenues. Securities firms employ approximately 750,000 individuals in the United States. (More information about SIA is available on its home page: <http://www.sia.com>)

² Securities Exchange Act Release Nos. 46818 (November 12, 2002), 67 FR 69782, and 46817 (November 12, 2002), 67 FR 69785.

³ See Securities Exchange Act Release No. 46416 (August 23, 2002), 67 FR 55901.

change the effect of those original filings. Consequently, SIA's concerns remain much the same as those expressed in our comment letter of September 26, 2002.⁴

SIA believes the Securities and Exchange Commission ("SEC" or "Commission") and NASD should reconsider the process for imposing or changing significant fees imposed on self-regulatory organization ("SRO") members. As we have noted many times, SIA fully supports self-regulation and member firm funding of SRO activities. In fact, after the initial proposal to revise the NASD regulatory fee was rejected by the industry, SIA offered to assist the NASD in determining how funding should be shared among firms in an equitable manner and administered in an efficient and accurate reporting and collection system. Although the NASD worked diligently to keep the industry informed of their deliberations as the new pricing structure evolved, there was little opportunity for industry input or public debate. This is critical, particularly because SRO fees take on a new level of importance in the current environment of intense competition among market centers. Although they ultimately may prove to be transparent, equitable, and beneficial to firms, because of the competitive implications, the industry should be given more opportunity to participate in the process before changes are announced as effective.

SIA believes that the NASD should not have filed its TAF proposal as immediately effective upon filing. SIA believes that wholesale revisions to the pricing structure, such as those proposed by the NASD in this instance, although fairly characterized as fee changes, should nevertheless be filed for full notice and comment.⁵ The filing should include a discussion of the financial impact of all aspects of the proposal, for both member firms and the SRO, which includes the assumptions used in determining the impact of the proposal. Finally, because virtually all fee changes will involve programming changes, such changes should not be adopted until firms have had the time to implement and test the operational changes that are required. Undoubtedly, SIA member firms will vary in their views of the revised pricing structure, but all agree that the process should provide firms the ability to evaluate the impact of proposed changes, to challenge the appropriateness of the changes, and to program and test changes well in advance of the effective date.

⁴ See letter to Jonathan G. Katz, Secretary, SEC, from Stuart J. Kaswell, Senior Vice President and General Counsel, dated September 26, 2002, commenting on the NASD's proposed regulatory pricing structure set out in File Nos. SR-NASD-2002-98 (Trading Activity Fee, or "TAF") and SR-NASD-2002-99 (Gross Income Assessment, or "GIA," and Personnel Assessment, or "PA").

⁵ SIA notes that the NASD did, in fact, submit proposed modifications to the GIA and PA for notice and comment. Because these changes were integrally related to the TAF, however, it was difficult for firms to review and comment on these changes in isolation.

I. Background

The NASD first sought comment on proposed changes to its pricing structure in NASD Notice To Members (“NTM”) 02-09, issued in February of 2002. In response to adverse comment from the industry, the NASD developed an alternative, which was described in NASD NTM 02-41 issued in July 2002.⁶ The NASD filed this alternative with the Commission in two separate rule filings that, when viewed as a whole, are designed to revise the NASD’s member regulatory pricing structure without significantly changing the amount of revenue collected by the NASD. According to the NASD, the proposed changes were designed to better align NASD’s member regulatory fees with its functions, efforts, and costs. The NASD acknowledges that various firms will be impacted differently. The proposal was developed and presented to the industry, including members of the SIA, before being filed with the Commission, but no industry-wide comment was sought at that time.

The proposal contemplated three types of fees and assessments: the new TAF, and modification of the existing Gross Income Assessment (“GIA”) and Personnel Assessment (“PA”). The TAF was filed for immediate effectiveness and was set to become effective September 1, 2002 (later changed by amendment to October 1, 2002), although the rate was not announced.⁷ Market participants therefore were unable to evaluate the impact of that change, and to determine whether the impact might be offset or exacerbated by the proposed changes to the GIA and PA, which were filed for notice and comment.⁸ In fact, the TAF rate was not announced until late in September, just days before the TAF was to become effective.⁹ Subsequently, in mid-October, the NASD announced adjustments to the rates and created a per trade maximum and a *de minimis* exception, complicating firms’ programming efforts that were currently underway.¹⁰ Firms are just now beginning to understand the impact that the revised pricing structure, which to some extent has already become effective, will have on their firm.

In response to the original rule proposals, several SROs expressed concerns with the proposed TAF and urged the Commission to exercise its authority to abrogate the rule

⁶ NTM 02-41 only announced NASD Board of Governor approval of the proposed changes and did not solicit comment.

⁷ See *supra* note 3.

⁸ See Securities Exchange Act Release No. 46417 (August 23, 2002), 67 FR 55893.

⁹ See September 27, 2002 announcement regarding NASD Trading Activity Fee Initial Rates.

¹⁰ See October 17, 2002 announcement regarding Adjustment to NASD Trading Activity Fee Initial Rates. Although the TAF is modeled closely on fees assessed under Section 31 of the Securities Exchange Act of 1934, those fees are based on the aggregate dollar amount of the sell-side of a transaction. The TAF, on the other hand, is assessed on a per share basis. Consequently, significant additional programming is required.

filing.¹¹ The SIA, in commenting on the proposals, noted the cooperative efforts of NASD since initially announcing changes to the fee structure, but strongly urged that the proposed TAF be withdrawn and refiled under Section 19(b)(2) of the Securities Exchange Act of 1934 ("Exchange Act") so that firms could provide substantive comments on the TAF, particularly as it relates to proposed changes to the GIA and PA. The instant filings mirror the previous rule changes published by the Commission regarding the TAF, but presumably are designed to address concerns raised by commenters by providing additional opportunity for comment. Under the two filings, the Commission must act affirmatively to approve File No. SR-NASD-2002-148 or, pursuant to SR-NASD-2002-147, the TAF will terminate on December 31, 2002 without the need for the Commission to abrogate. The filings also incorporate changes to the TAF that were announced in NTM 02-75 on October 30, 2002; specifically, the NASD has reduced the TAF rate by 50% and extended the payable date for the October through December TAF to January 15, 2003.

Although SIA appreciates NASD's willingness to expose the proposal for public comment at this point, we believe the implementation issues the firms are struggling with today would have been avoided if it were filed for notice and comment at the outset. Part of the difficulty with implementation is that the NASD is responding to individual member firms with a series of incremental changes, such as the rate reduction announced most recently, that necessitates continuous programming changes. While we appreciate the NASD's efforts to be responsive to the membership, the better course would have been to solicit comment and make modifications before adoption of the TAF.

II. Established Procedure for Filing Structural Fee Changes

Section 19(b) of the Exchange Act¹² requires that every SRO file with the Commission copies of any proposed rule or any proposed change in, addition to, or deletion from the rules of such SRO, accompanied by a concise general statement of the basis and purpose of such proposed rule change. The Commission is required to publish notice of the filing of a proposed rule change and to give interested persons an opportunity to submit written data, views, and arguments. Section 19(b) provides that the Commission shall approve an SRO's proposed rule change if it is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the SRO.

¹¹ See letter to Jonathan G. Katz, Secretary, SEC, from The American Stock Exchange, Chicago Board Options Exchange, International Securities Exchange, Inc., The Options Clearing Corporation, Pacific Exchange, Inc., and Philadelphia Stock Exchange, dated September 20, 2002, and letter to Jonathan G. Katz, Secretary, SEC, from Edward J. Joyce, President and Chief Operating Officer, Chicago Board Options Exchange, dated September 18, 2002.

¹² 15 U.S.C. 78s.

A proposed rule change may take effect when approved by the Commission by order, unless the rule change is within the class of rule changes that are effective upon filing pursuant to Section 19(b)(3)(A).¹³ Under Section 19(b)(3)(A) of the Exchange Act and Rule 19b-4(e) thereunder, a proposed rule change may take effect upon filing, without the notice and approval procedures required by Section 19(b)(2), if the proposed rule change comes within the prescribed statutory categories, which include rule changes that (1) constitute a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the SRO, (2) establish or change a due, fee, or other charge imposed by the SRO, (3) are concerned solely with the administration of the SRO, or (4) are matters which the Commission may, consistent with the public interest and the purposes of this subsection, specify by rule. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.

In 1994, in a release adopting amendments to Rule 19b-4, the Commission stated that significant new fees should be filed under Section 19(b)(2) rather than Section 19(b)(3)(A). Specifically, the release states: “[U]nder Section 19(b)(3)(A)(ii) of the [Exchange] Act, rule changes that establish or change a due, fee, or other charge imposed by the SRO may become effective upon filing. The Commission notes that the filing of a proposed fee applicable to members may nonetheless raise significant regulatory issues and thus be required, consistent with current Commission policy, to be submitted pursuant to Section 19(b)(2).”¹⁴

SIA believes that the Commission should be diligent in exercising its oversight authority to narrowly construe the scope of rule changes that can be filed pursuant to Section 19(b)(3) of the Exchange Act to ensure that all rule proposals – including fee proposals – that raise substantive issues and propose far-reaching changes are filed under Section 19(b)(2), thus allowing for full notice and comment prior to effectiveness.

Although the TAF has been refiled under Section 19(b)(2) for comment, the companion filing establishing the sunset provision, submitted under Section 19(b)(3)(A), essentially confirms the effectiveness of the TAF while the comment process is underway. While this entire process serves the objectives of the NASD to implement the fee changes quickly, it has resulted in a significant burden on firms trying to quickly implement and keep up with the frequent changes.

¹³ 15 U.S.C. 78s(b)(3)(A).

¹⁴ Securities Exchange Act Release No. 35123 (December 28, 1994), 59 FR 66692.

III. Substantive Issues

As the NASD notes, the TAF is imposed on trading in all markets because it is designed to fund NASD's member regulation activities, including supervision and regulation of members through examinations, processing of membership applications, financial monitoring, and policy, rulemaking, interpretation and enforcement activities. SIA recognizes that trading activity drives regulatory costs. Although assessing a fee on trading activity occurring in other markets may be justified given the NASD's responsibility for *member* regulation, this action is unprecedented and the implications should be carefully considered. Many SIA member firms fear that other SROs will follow suit with their own TAF and firms could end up paying considerably more than the fair cost of regulation. For example, because jurisdiction of SROs overlaps with respect to common members, Exchange Act Rule 17d-1 provides for designation of a primary regulator for common members in certain instances ("designated examining authority," or "DEA"). After taking into account responsibilities that may be delegated to the SRO pursuant to Rule 17d-2, other SROs may choose to assess their own TAF to fund certain regulatory activities.

SIA supports the NASD's efforts to make the pricing structure more transparent. Firms believe, however, that more specific information is required. Given this significant expansion of the scope of the fee, and the possible precedential effect it may have in the industry, we believe that the NASD should be required to provide in more detail a fair and reasonable basis for expanding the scope of the TAF to cover transactions executed in any market. In addition, where fees are presented to the industry as "revenue neutral" or "fair and reasonable," the rule filing should contain data that demonstrates that this is true. Also, for major revisions to an SRO's pricing structure such as this, the filing should be accompanied by data showing that the SRO has conducted a financial analysis, including the assumptions on which that analysis is based. For example, the SRO should include volume assumptions and/or the rates on which the conclusion is based. Firms also believe that volume-based rates should be adjusted periodically, and that the SRO should include information on this point in its filing as well. It is not clear from the filings that NASD has performed such an analysis; in fact, a stated purpose of one of the filings is to allow the NASD to examine the impact of the published TAF rates currently in effect.

Although this comment letter focuses primarily on the TAF, each of the NASD's fee proposals cannot be evaluated separately but must be considered together as a package. In this respect, some member firms also have noted the lack of information about, and rationale for, the "expanded" GIA calculation. The NASD's GIA proposal will result, in part, in revenue from a firm's non-securities-related business (such as its commodities business) being included in the calculation of "gross revenue," and thus the firm will pay an assessment on such revenue. Several firms question the NASD's rationale for, and the regulatory nexus between, including such non-securities related revenue in the calculation of the GIA and the NASD's costs of examining their member

firms, as the NASD does not have regulatory oversight authority over or responsibility for its member firms for, and does not regulate, those non-securities-related businesses. These firms believe that the NASD should be required to provide a reasonable basis and nexus for including such revenue. For instance, does an examination for financial and operational compliance by the NASD in those instances where the NASD is the DEA for a member, pursuant to Rule 17d-1, necessarily include a review of the financials related to all of the firm's business activity and not just its securities-related activity? If that is in fact the case, the NASD should, at a minimum, be required to limit the inclusion of non-securities related business revenue to those member firms for which it acts as the DEA. One firm noted that the NYSE, after proposing a similar fee in 1983, responded to comments by amending its proposal to apply only to those firms for which it was the DEA.¹⁵

IV. Effective Date of Fee Filings Should Accommodate Programming Changes

As noted above, implementation of the TAF has been complicated by a series of changes announced after the fee became effective. Specifically, in mid-October, based on further analysis of trading volumes, the NASD adjusted the initial rates to incorporate a per trade maximum fee retroactive to October 1, 2002. Additionally, in that notice, the NASD indicated that, if the execution price for a covered equity security is less than the TAF rate on a per share basis, then no fee would be assessed. Later in October, the NASD again adjusted the rate based on feedback from member firms, reducing it by 50%. At this time, the NASD announced that it had extended the submission and payment date for the October 1, 2002 through December 31, 2002 time period until January 15, 2003.

Although SIA appreciates the accommodation with respect to the submission and payment date, we respectfully request that any further changes made to the calculation method as a result of the comment process or feedback from individual firms be made effective no sooner than ninety days after final approval of the rule by the SEC. Additionally, as with SEC Section 31 fee rate changes, the NASD should provide at least 30 days notice in advance of a rate change. Moreover, once firms have hard coded their systems to exclude trades where the price is below .0001, this exception should not be tied to the rate. Firms believe that the *de minimis* exception should remain at .0001, regardless of the rate. Finally, any rate change should occur at the beginning of the month rather than in the middle.

Clearing firms will self-report aggregate volume to the NASD on a monthly basis, and will be required to remit appropriate amounts within 10 business days following the end of the month. Similar to the practice with the Section 31 fee, many firms and service bureaus are building the capability to pass the TAF on to the end client. If firms round up to the nearest penny, the clearing firm may collect more than is owed. The SEC and

¹⁵ See Securities Exchange Act Release No. 20337 (October 31, 1983).

NASD should address the question of what firms should do with the additional funds collected as a result of such rounding.

V. Conclusion

SIA appreciates the opportunity to provide comments on this significant change to the NASD pricing structure. Our concerns revolve primarily around process rather than substance.

To summarize the discussion above as it relates to future SRO fee proposals involving structural or significant fee changes, SIA recommends that:

- (a) firms be given an opportunity to express their views prior to the new fee becoming effective;
- (b) fee proposals that require programming changes not be made effective until the industry has had sufficient time to program and test the necessary changes; and
- (c) where fees are presented to the industry as “revenue neutral” or “fair and reasonable,” that the rule filing contain data that demonstrates that this is true, *e.g.*, volume assumptions and/or rates on which the conclusion is based, and also a representation that volume-based rates will be adjusted periodically to take into account changes in market volume.

SIA notes that the NASD has demonstrated a commitment to address concerns of member firms as the revised pricing structure is rolled out, and we look forward to continuing to work with NASD staff on this process. If we can provide further information or clarification of the points in this letter, please contact me or Ann Vlcek, Associate General Counsel, at 202.296.9410.

Sincerely,

Stuart J. Kaswell
Senior Vice President and
General Counsel

cc: Annette L. Nazareth, Director, Division of Market Regulation, SEC
Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC
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