

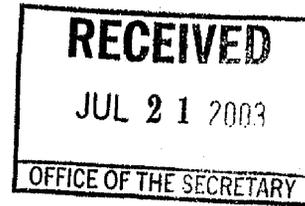


CINCINNATI
STOCK EXCHANGE

Jeffrey T. Brown
Senior Vice President, Secretary
and General Counsel

July 17, 2003

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
Mail Stop 5-1
450 Fifth Street, N.W.
Washington, DC 20549



Re: Release No. 34-48061; File No. SR-NASD-2003-93

Dear Mr. Katz:

The Cincinnati Stock Exchange ("CSE") respectfully submits the following comments on the National Association of Securities Dealers, Inc.'s ("NASD's") proposed rule change, SR-NASD-2003-93, which pertains to NASD's trading activity fee ("TAF").¹ Recognizing that these comments are submitted after the expiration of the comment period, CSE requests that the Securities and Exchange Commission ("Commission") nevertheless consider these comments in its review of the proposed rule change.

Through SR-NASD-2003-93, NASD is seeking to double its fee and maximum charges applicable to transactions in equity securities.² We note that NASD, however, is not proposing to charge fees for regulating member activity in non-listed over-the-counter ("OTC") products, as requested by the Commission in the TAF Approval Order, or to increase the TAFs charged for options or securities futures.³ NASD is also not proposing any changes to its Gross Income Assessment ("GIA") or Personnel Assessment ("PA"), which are combined with the TAF to fund NASD's member regulatory activities.

CSE believes that NASD's proposal is a classic example of, "we told you so!" The ink wasn't even dry on the TAF Approval Order⁴ when NASD attempted what we predicted and feared: to double the ill-defined TAF with no justification on its part and little check or recourse on the part of the non-NASD markets.⁵

¹ Securities Exchange Act Release No. 48091 (June 19, 2003), 68 FR 37887 (June 25, 2003)(SR-NASD-2003-93)("TAF Increase Proposal").

² NASD is proposing to increase the TAF for equity securities from \$0.00005 to \$0.0001 per share and to increase the maximum charge per trade from \$5 to \$10. *Id.* at 37888

³ The TAF for options contracts (\$0.002 per contract) and security futures (\$0.04 per contract) will remain unchanged. *Id.*

⁴ Pursuant to delegated authority, the Commission's Division of Market Regulation recently approved the TAF on May 30, 2003. Securities Exchange Act Release No. 47946 (May 30, 2003), 68 FR 34012 (June 6, 2003)(SR-NASD-2002-148)("TAF Approval Order"). Ten days later, NASD submitted the instant proposal.

⁵ See, e.g., letters from Jeffrey T. Brown, Senior Vice President, Secretary & General Counsel, CSE to Jonathan G. Katz, Secretary, Commission, of September 27, 2002 (commenting on SR-NASD-2002-98) and December 10, 2002 (commenting on SR-NASD-2002-148).

NASD makes no attempt to justify the fee increase, other than to state that it received lower than expected TAF revenues. We find this startling given NASD's proposed 100% increase in the TAF. Did NASD really underestimate TAF revenue by 100%? Have total transactions by NASD members been 100% less than they were last October, when NASD proposed the original TAF? We do not think that is so. Instead, the only purpose we can find behind this proposal is NASD's desire to have transactions on CSE and other markets subsidize regulatory efforts on the NASD for which NASD does not want to charge directly.

At least there may be a silver lining with this proposal. It seems apparent that NASD failed to provide adequate justification for the imposition of the fee in the first part. Maybe now that deficiency can be rectified. Given the controversial fee structure, we believe NASD should be required to submit sufficient justification and supporting documentation before the Commission considers doubling the fee. Simply indicating that NASD had "lower than expected TAF revenues" is not enough. Likewise, simply indicating that NASD has "broad responsibilities" is not enough. NASD must clearly define its responsibilities covered under the TAF, explain how those responsibilities are unique to NASD, and provide a detailed cost analysis establishing a nexus between the responsibilities and fees. Further, this information must be made available for public scrutiny. After all, since our members and their customers are forced to provide this subsidization, shouldn't we understand what services are being paid for? Perhaps if NASD had been required to submit a detailed cost justification for public review initially, their original miscalculation might not have occurred.

DISCUSSION

There generally exists a principled, consistent and relatively simple approach to regulatory responsibilities and fees. A self-regulatory organization ("SRO") typically supports its regulatory program, as well as its overall business operations, through funds generated in its markets and fees assessed to its members, issuers and users. In this context, we tend to agree with NASD that these fee structures employed by the SROs need not be "so specific and complex as to tie specific self-regulatory programs and related expenses to specific business lines within a firm."⁶

The line is drawn, however, when it comes to the imposition of a regulatory fee based on activity occurring on other SROs' markets. The notion of an intermarket fee of this nature is rare and not without controversy. Until NASD came along with its TAF and expanded GIA just less than a year ago, intermarket fees had only been considered in the contexts of designated examining authority ("DEA") assignments, Rule 17d-2 arrangements and regulatory service agreements. In these limited circumstances where intermarket fees are assessed a higher standard of justification applied. A clear nexus was always established. Certain checks and balances existed. These types of intermarket fees were discrete and tailored to the specific regulatory function and are generally only assessed by the designated primary regulator. For example, until NASD expanded it, GIA fees had been designed to recoup expenses of DEAs for performing financial and operational exams of their designated members. As multiple markets perform this function, competitive forces play a role in gauging the reasonableness of the fees

⁶ See Securities Exchange Act Release No. 47106 (December 30, 2002), 68 FR 819, 820 (January 7, 2003)(SR-NASD-2003-99)(NASD GIA and PA Approval).

assessed to perform that function. Rule 17d-2 arrangements and regulatory service agreements have an added check in so much as the affected markets consider the reasonableness of the fees charged when determining whether to continue the relationship.

Intermarket fees of this nature stand in stark contrast to the fee structures NASD has enacted over the unanimous objection of the industry. NASD's TAF and GIA have altered the balance that once existed by disregarding the primary regulator component characteristic of other intermarket fees and by allowing for the subsidization of NASD regulatory activities through the forced taxing of transactions occurring on other markets. This is all accomplished under the guise of revenue neutrality to NASD.

The amorphous concept of "revenue neutrality" appears to be defined from NASD's perspective to mean its total revenue generated from all sources remains constant.⁷ NASD does not define neutrality from the perspective of treating individual sources of revenue equality. For example, the TAF is not "revenue neutral" to individual types of securities, *e.g.*, NASD is seeking to double the TAF for equities, maintain the separate rate for options and for security futures, and continue to charge nothing for unlisted OTC securities. The TAF is also not "revenue neutral" to individual markets, *e.g.*, the stock markets subsidize NASD through the TAF without regard to DEA status, the options markets subsidize based on designated options examining authority ("DOEA") status, and the debt, mutual fund, variable annuity and unlisted OTC markets (aka NASD's markets) bear no TAF. Moreover, the TAF is not "revenue neutral" between NASD-regulated and non-NASD-regulated markets, *e.g.*, generally only the NASD markets benefit from the TAF. Other markets, particularly the non-NASD equities markets, bear the financial burden of the TAF yet get no corresponding monetary or other benefit. While NASD's regulatory expenses should not become other markets' burden simply because of a change in corporate structure or shift in trading away from Nasdaq to competing markets: NASD has sought to achieve just this through the institution of the TAF and the instant proposal to double the TAF for equities securities. Thus, under the TAF and GIA structures, NASD takes not so much from its own, but most significantly from other markets, to come up with its "revenue neutral" pie. We do not believe that NASD is not entitled to revenue neutrality in this respect.

The Commission approved the TAF and GIA despite the fact that markets complained that the NASD should provide, "more specific information about the costs to be borne by the NASD, and the relationship of those costs to the fees the NASD intends to charge . . ."⁹ Before the Commission goes the further step of allowing NASD to double its fees under this structure, thus doubling the cost of business of competing equities markets while NASD remains in a "revenue neutral" position, we believe a detailed accounting is necessary. This accounting is needed given the unique structure of this intermarket fee, the inherent conflict of interest that exists on NASD's part, and the recognition that the TAF is used to subsidize non-equity markets. In order to justify an increase to an intermarket fee of this nature, we believe NASD must:

⁷ See TAF Increase Proposal, 68 FR at 37888 ("[s]ix months' experience with the TAF has demonstrated that the initially proposed rate is more accurate to ensure revenue neutrality and adequate funding").

⁸ NASD GIA and PA Approval, note 8, *supra*.

⁹ Letter from Darla Stuckey, Corporate Secretary, New York Stock Exchange, to Jonathan G. Katz, Secretary, Commission (December 11, 2002).

- (1) clearly define the regulatory activity(ies) that the TAF will be used to cover and establish that the regulatory activity(ies) is exclusively within NASD's jurisdiction;
- (2) establish a nexus between the fee and the regulatory activity(ies); and
- (3) disclose the amount to be assessed, the overall amount expected to be generated through the imposition of TAF, and the cost of the regulatory activities being funded; and represent that the revenues collected will not exceed those expenses directly related to the regulatory activity being performed.

As DEAs are required to meet this standard in the context of the intermarket GIA, this standard at a minimum should be required in the instance of NASD's TAF increase, which applies regardless of NASD's regulatory status. If, on the other hand, DEA status is not a critical component of assessing intermarket fees and this higher standard of justification does not apply, the public at a minimum deserves to know what makes the present circumstances unique.¹⁰

In addition, in evaluating this proposal the Commission's analysis must also consider its own recommendation that NASD expand the TAF to other OTC products. In this brief time since the approval of the TAF, NASD appears to have not heeded the Commission's urging to undertake to "better allocate [its] regulatory costs" to recoup expenses through the areas that NASD is clearly responsible for overseeing, such as debt, mutual funds, variable annuities and unlisted trading in the OTC market.¹¹ Careful consideration of the Commission's recommendation seems to have been tossed to the wayside along with NASD's representation that it would progressively reduce the percentage that the TAF contributes to the its overall funding structure.¹² Although NASD claims it will consider reducing the TAF in the future, it is difficult to take any comfort from this when today it is seeking to double the fee for equity securities. This is simply not a reasonable and equitable allocation of dues and fees among members as required by the Act.¹³

Given these circumstances, there should be an examination of the reasons why the equities markets are being asked again to subsidize NASD while the NASD markets are not. Why should the equities markets, NASD's primary competitors, be the ones to bear this burden? Moreover, given that the TAF, GIA and PA are interrelated and combined into a single structure to keep NASD revenue neutral, shouldn't NASD be justifying changes in relation to the overall structure, not by isolating this single component? Again, given the unique structure of this intermarket fee, NASD's inherent conflict of interest, and the recognition that the TAF is already used as a subsidization, we believe NASD must satisfy a higher standard to justify its proposed fee increase. The information NASD has currently made available is not sufficient to make the case.

* * *

In conclusion, CSE respectfully requests that the Commission consider the arguments set forth by CSE with respect to SR-NASD-2003-93. CSE urges the Commission to require that NASD

¹⁰ To make matters more confusing, the TAF for options transactions has been limited to members for whom NASD is the DOEA. If regulatory status is relevant in that context, we fail to see how NASD's DEA status should not be a factor in the application of the TAF generally.

¹¹ TAF Approval Order, 68 FR at 34024.

¹² TAF Increase Proposal, 68 FR at 37888.

¹³ Section 15A(b)(5) of the Act.

submit more detailed information necessary to justify the price increase and to permit a full comment on the matter. Barring NASD's satisfaction of these requirements and in light of the apparent lack of a distinct nexus between the TAF and the regulatory activities imposed, the Commission should begin disapproval proceedings of the proposed increase to the TAF in accordance with the provisions of Section 19(b) of the **Act**. On a broader level, we believe the instant proposal makes real the concerns expressed by the industry during the TAF comment process. We therefore urge the Commission to reconsider the arbitrary and anticompetitive implications of NASD's continued application of this intermarket fee structure.

Sincerely,



/Jeffrey T. Brown
Senior Vice President and General Counsel

- cc. The Honorable William H. Donaldson
Chairman, Securities and Exchange Commission
- The Honorable Paul S. Atkins
Commissioner, Securities and Exchange Commission
- The Honorable Roel C. Campos
Commissioner, Securities and Exchange Commission
- The Honorable Cynthia A. Glassman
Commissioner, Securities and Exchange Commission
- The Honorable Harvey J. Goldschmid
Commissioner, Securities and Exchange Commission
- Ms. Annette L. Nazareth
Director, Division of Market Regulation
- Ms. Lori Richards
Director, Office of Compliance Inspections and Examinations
- Mr. Robert L.D. Colby
Deputy Director, Division of Market Regulation
- Mr. John McCarthy
Associate Director, Office of Compliance Inspections and Examinations