



National Association of Securities Dealers, Inc.

Profile

The National Association of Securities Dealers, Inc. (NASD®) is the largest securities industry self-regulatory organization in the United States. It operates and regulates The Nasdaq Stock MarketSM—the world's largest screen-based stock market and the second largest securities market in dollar value of trading—and other screen-based markets. The NASD also oversees the activities of the U.S. broker/dealer profession and regulates Nasdaq® and the over-the-counter securities markets through the largest self-regulatory program in the country.

The NASD consists of a parent corporation that sets the overall strategic direction and policy agendas of the entire organization and ensures that the organization's statutory and self-regulatory obligations are fulfilled. Through a subsidiary, The Nasdaq Stock Market, Inc., the NASD develops and operates a variety of marketplace systems and services and formulates market policies and listing criteria. Through another subsidiary, NASD Regulation, Inc., the NASD carries out its regulatory functions, including on-site examinations of member firms, continuous automated surveillance of markets operated by the Nasdaq subsidiary, and disciplinary actions against broker/dealers and their professionals.

Origin

The NASD was organized under the 1938 Maloney Act amendments to the Securities Exchange Act of 1934 by the securities industry in cooperation with the U.S. Congress and the U.S. Securities and Exchange Commission (SEC). Securities industry representatives—recognizing the need for, and actively seeking the responsibilities of, self-regulation—worked with the SEC to obtain this legislative authority.

Putting into practice the principle of cooperative regulation, the Maloney Act authorized the SEC to register voluntary national associations of broker/dealers for the purpose of regulating themselves under SEC oversight. The NASD is the only securities industry association to have been established under the Maloney Act amendments. Presently, all securities firms in the United States that transact business with the public are required by law to be a member of the NASD.

The NASD's founding mandate was to standardize the securities industry's principles and practices, to promote high standards of commercial honor, to advance just and equitable principles of trade for the protection of investors, to adopt and enforce rules of fair practice, and to foster observance by its members of federal and state securities laws.

The NASD, taking direction from the SEC in 1963, has also adopted, as another tenet of its self-regulatory mandate, the promotion of capital formation by developing, operating, and regulating fair and efficient screen-based securities markets. The Nasdaq Stock Market was founded in 1971 to fulfill this mandate.

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NASD Board of Governors

MISSION

To facilitate capital formation in the public and private sectors by developing, operating, and regulating the most liquid, efficient, and fair securities markets for the ultimate benefit and protection of the investor.

Serving Investors And Companies Worldwide

Facilitating Economic Growth

The National Association of Securities Dealers, Inc. (NASD®) facilitates capital formation by providing fair, efficient, and liquid securities markets for the benefit of companies and investors worldwide. These Information Age markets have a solid technological foundation and are well regulated for the safety and protection of the providers of capital—investors.

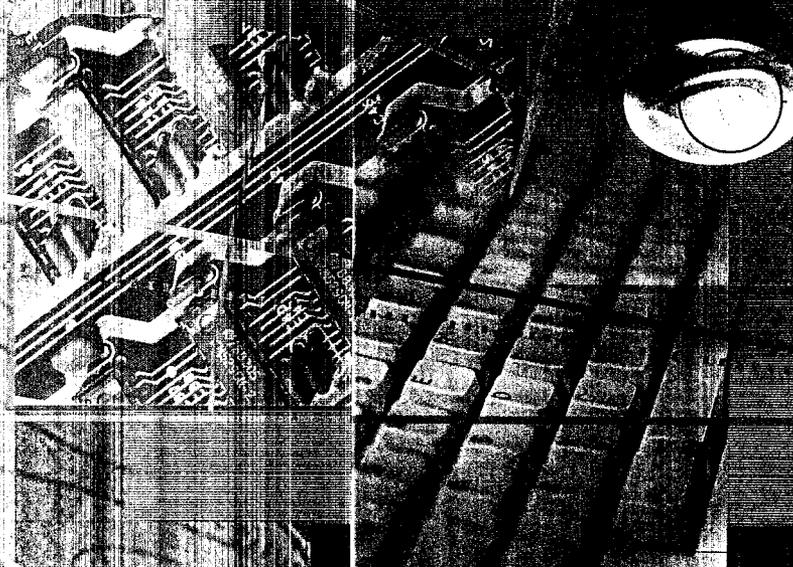
The United States is fortunate to have the most efficient and best regulated markets in the world. A national network of self-regulatory organizations operating under the oversight of the U.S. Securities and Exchange Commission (SEC) plays a central role in providing quality markets deserving of investors' trust.

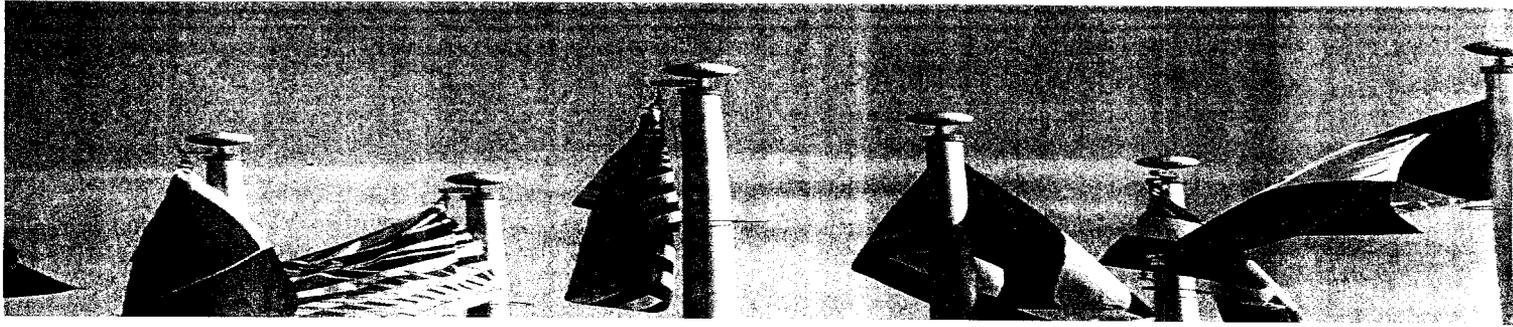
The NASD is the largest self-regulatory organization for the securities industry in the United States. Presently, every broker/dealer in the nation that conducts a securities business with the public is required by law to be a member of the NASD. The NASD's membership is comprised of more than 5,500 securities firms which operate over 60,000 branch offices and employ more than 535,000 registered representatives. The NASD serves companies and investors on all continents of the globe.

For over one-half century, the NASD has protected investors through the enforcement of federal securities laws as well as the broader ethical requirements of its own rules, which obligate members to observe high standards of commercial honor.

The screenshot shows a web browser window displaying the NASD website. The browser's address bar shows the URL <http://www.nasd.com>. The website header includes the NASD logo and the text "Welcome To The National Association of Securities Dealers, Inc.". Below the header, there is a navigation menu with links for "Home", "About Us", "Contact Us", "Member Services", "Investor Services", "Regulatory", "Market Data", "Financial Products", "Specialties", "Research", and "Services". The main content area features a prominent announcement: "Initial Results - New SEC Rules". The text below this announcement reads: "Developing, operating, and regulating the most liquid, efficient, and fair securities markets for the ultimate benefit and protection of the investor." At the bottom of the page, there is a copyright notice: "© 1997 National Association of Securities Dealers, Inc. All rights reserved. Please Read our Terms of Use."

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.





Managing an Economic Institution

Fulfilling its mission of helping the private sector raise capital to finance growth and create jobs, the NASD, through its subsidiary, The Nasdaq Stock Market, Inc., develops, operates, and regulates a variety of marketplace systems and services. Its flagship market, The Nasdaq Stock MarketSM, is internationally recognized as an engine of economic growth.

Today, The Nasdaq Stock Market accounts for more than one-half of all equity shares traded in the United States each day and is the second largest stock market in dollar value of trading in the world. More companies—domestic and foreign—list their securities on Nasdaq[®] than on all other U.S. stock markets combined.

Presently, EVERY broker/
dealer in the nation that
conducts a securities
business with the public IS
REQUIRED by LAW to be a
member of the NASD.

The Nasdaq market is the largest electronic, screen-based stock market in the world, capable of handling trading levels in excess of one billion shares a day and eventually two billion in 1998. Trading in the Nasdaq market is supported by multiple Market Makers—-independent dealers who openly compete with one another for investors' orders in each Nasdaq security.

Founded in 1971, the very design of the Nasdaq market takes advantage of Information Age technologies, many of which its listed companies developed. Using advanced computer and telecommunication systems, the Nasdaq market enables securities firms to execute transactions from anywhere they are located in an environment of real-time trade reporting and automated market surveillance.

Known for its innovative, leading-edge growth companies, Nasdaq has two tiers: the Nasdaq National Market[®], with Nasdaq's larger corporations whose securities are the most actively traded, and The Nasdaq SmallCap MarketSM, with emerging growth companies.

A pioneer in applying advanced technologies to securities trading, Nasdaq employs a wide range of sophisticated, interactive facilities to collect, process, and disseminate trade and quotation information; a complement of order-execution and negotiation systems; an on-line MarketWatch unit for automated market surveillance; and a variety of on-line informational and other services provided to Nasdaq companies and Nasdaq market participants.



Fair and efficient securities markets are the foundation upon which investment capital is raised to help companies produce new products and services, create jobs, conduct research, and innovate. In so doing, they make a better life possible, raising the standard of living for the citizens of the world.

The NASD, as the owner, operator, and regulator of The Nasdaq Stock Market, plays a vital role in the global economy as the prime economic engine for capital formation. It will continue to perform this critical function as the demand for capital continues to rise. Everything we do is carefully evaluated in terms of how it will ultimately affect the investor. We know that when regulation protects investors and markets serve them, everyone benefits—not just investors but companies and financial intermediaries alike.

To retain and enhance their relevancy, all significant institutions, particularly those serving a broad public responsibility, must periodically undergo critical evaluation. The great ones are continually learning and responding, growing better and stronger. The NASD is that kind of institution, always seeking to improve upon what it does. We believe in ourselves and our mission.

We respond with deeds, not words. We demonstrate our values through the ways in which we regulate our industry and run our markets.

Our goal for the future is to set the standard for market quality, regulatory fairness, and technology application. As the largest self-regulatory organization in the United States and the one that pioneered screen-based trading—building Nasdaq into the most active securities market in the United States and the second largest in the world—we have assumed for ourselves the role of caretaker of a public trust. This is a responsibility we aggressively sought and willingly carry out under the oversight of the SEC.

As we look to the future, all of our initiatives—regulatory and market—will be pursued with a common vision. Leadership at the NASD will consist of many people pulling in the same direction, mutually supporting each other, mutually supportive of our common goals. I am extremely proud to have been chosen to lead this organization at this important time in its continuing evolution.

As the world's economies become more interdependent, the NASD welcomes the opportunity to serve the world's growth companies with markets that are open, fair, and efficient—markets that will facilitate growth and a better tomorrow for each of us.

Frank G. Zarb

*Chairman, Chief Executive Officer and President
The National Association of Securities Dealers, Inc.*



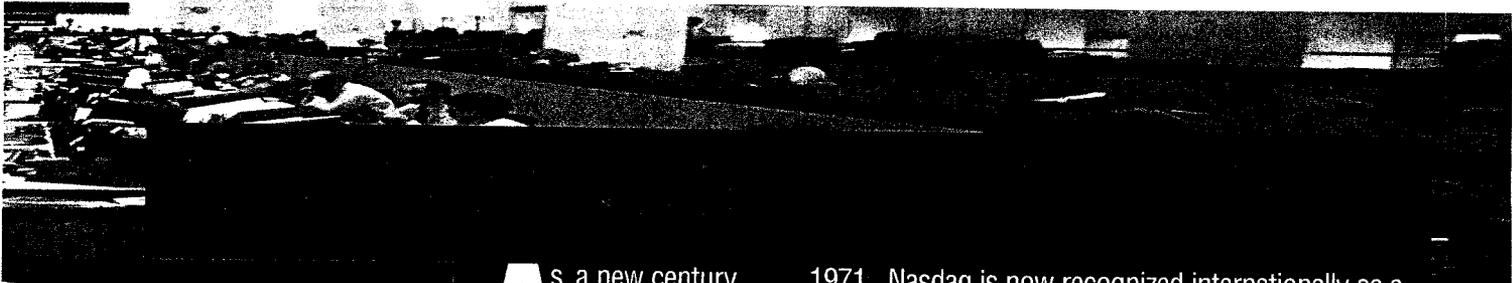
Guiding an Industry

The NASD is also the primary self-regulator of the securities industry in the United States. Through NASD Regulation, Inc., it regulates both the broker/dealer profession and the markets operated by The Nasdaq Stock Market, Inc. Many of the NASD's responsibilities go beyond the purview of other self-regulatory organizations.

In addition, the NASD provides a variety of regulatory-related services, including arbitration and mediation, to enable investors and broker/dealer firms to resolve disputes, as well as a telephone- and Web-based service to provide investors with background information on securities firms and their sales personnel.

The NASD protects investors and strengthens market integrity through a variety of programs and activities, including:

- registration, testing, and education of securities professionals;
- on-site examination of securities firms to determine and enforce their compliance with federal securities laws, the rules of the Municipal Securities Rulemaking Board (MSRB), and NASD rules and regulations;
- continuous automated surveillance of the markets operated by The Nasdaq Stock Market, Inc.;
- review of advertising and sales literature as well as underwriting arrangements proposed by securities firms in connection with new securities offerings;
- disciplinary actions against broker/dealer firms and their professionals who fail to comply with NASD rules, MSRB rules, or the federal securities laws;
- operation of a dispute resolution forum that provides mediation and arbitration services; and
- cooperative programs with governmental agencies and industry organizations to solve problems affecting investors, public companies, and securities firms.



As a new century approaches and a new information-driven economy emerges, securities investing has become increasingly important in the lives of millions of people around the world. There are more individual investors, with more invested. Because an increasing number are funding their own retirements, the markets are more important than ever for

the future economic security of people around the world.

At the same time, companies with global reach are seeking greater amounts of capital to respond to the increased pace of technological change. They look to raise money to improve productivity, create new jobs, and turn ideas into new industries and new products.

In today's environment of burgeoning investment, the NASD is firmly committed to meeting the needs of both providers and seekers of capital. In the last 12 months alone, it has established new standards for self-regulation, market efficiency, and fairness, continuing to earn the trust and confidence of investors and companies alike.

The extraordinary growth of The Nasdaq Stock Market has continued unabated since its founding in

1971. Nasdaq is now recognized internationally as a key global market for growth companies. Its unique combination of Information Age technology and dealer competition forged a new paradigm in the way stocks would be traded. Indeed, the Nasdaq experience is now replicated around the world. As a CNN market commentator said, Nasdaq is one of the most powerful financial market stories of our time.

For the future, Nasdaq is focusing on ways to improve liquidity, immediacy of trading, and other features of the market that have enabled it to grow and serve a diverse mix of market participants. Work has already begun on the next generation of systems that will enlarge trading capacity well beyond the present one-billion-share daily capacity.

On the regulatory front, the NASD is working to anticipate changes in markets, securities products, and technology that will require measures to educate and protect investors. The NASD is also building on a culture of vigorous enforcement and high professional standards, strengthening its processes of adjudication and dispute resolution.

The future of the global economy depends on the viability of our securities markets. The NASD is doing its part by striving for regulatory excellence and building markets that are the fairest and most efficient for investors and companies throughout the world.

Daniel P. Tully
*Former Chairman and Chief Executive Officer
Merrill Lynch & Co., Inc.*



Applying the Latest Computer and Communications Technology

Today the NASD is at the forefront of applying advanced technology to the securities industry. The NASD recognized early on that technological enhancements to securities trading, market surveillance, and regulatory oversight could provide real benefits to investors and companies.

The application of technology to securities trading was originally envisioned to enhance both regulation and market functionality. In 1963, in a special study of the securities markets submitted to the U.S. Congress, the SEC recommended that "the Commission and the NASD should jointly consider possibilities for developing and coordinating automation programs in such manner as to fulfill their respective regulatory needs, as well as operational needs of the markets."

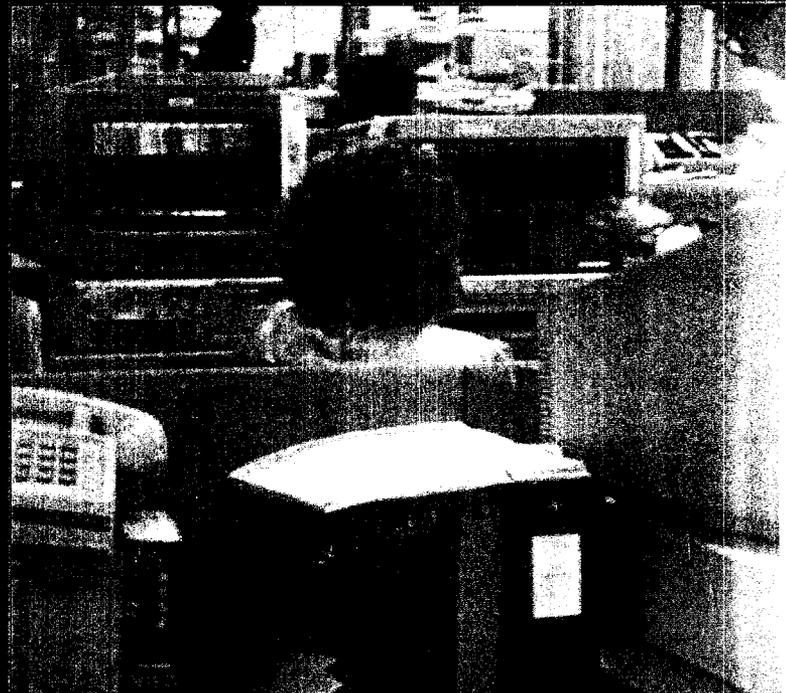
The NASD's answer to that mandate was The Nasdaq Stock Market. The NASD's design for Nasdaq proved to be so successful that in just two decades Nasdaq emerged as the world's largest screen-based stock market.

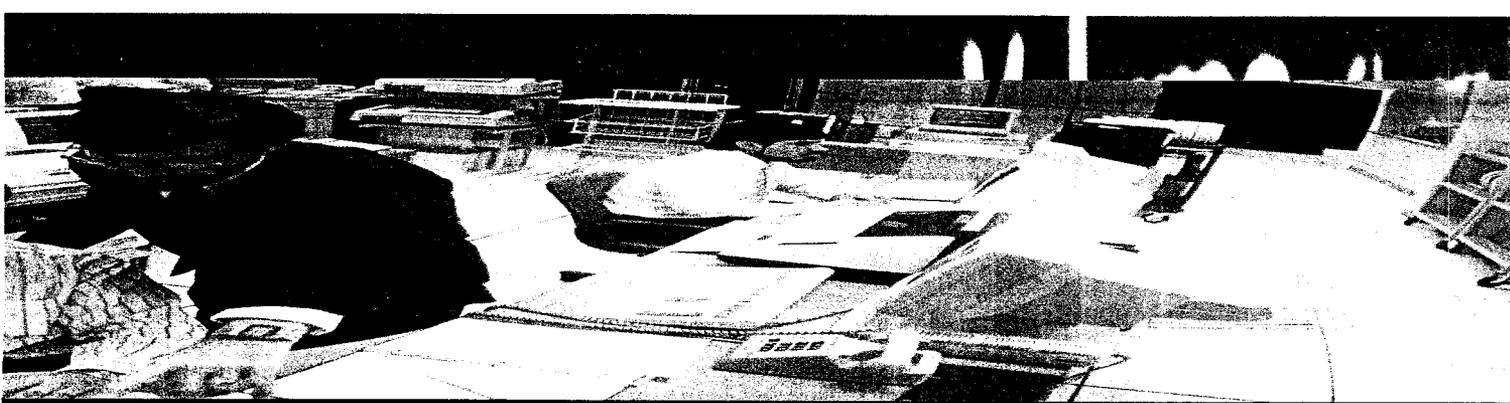
Over the years, the NASD has developed a vast array of trading services to complement the Nasdaq market's basic quotation service. The most recent trading service developed, in response to the new SEC Order Handling Rules, automates the display of private trading system quotes when better than the market quote, allowing investors to access those better prices

when buying and selling in The Nasdaq Stock Market.

Nasdaq's automated market surveillance systems are among the most advanced in the world. Developed with the help of two Nobel laureates, the StockWatch Automated TrackingSM system (SWATSM) records every bid and offer quotation and every trade in every security in the market as well as the computer from which the quote was entered or the trade was made.

Currently the NASD is completing a technology system that will virtually revolutionize market





surveillance. The Order Audit Trail SystemSM (OATSSM) will track electronically the handling of an investor order from the moment the firm receives it through its execution and settlement. This system will enable NASD RegulationSM staff to determine more efficiently whether a customer's order is executed promptly and given priority and best execution.

Perhaps the most dramatic demonstration of the NASD's ability to design and deploy advanced technological systems is the recent migration of The Nasdaq Stock Market to an entirely new computer system and telecommunications network. This the NASD was able to achieve while the market continued normal trading operations and services, handling record levels of volume.

This project represented the largest single technology conversion undertaken by a major stock market.

The NASD is already preparing the next phase of Nasdaq's trading system expansion, taking the next step in a continuing process to anticipate and meet investor demand. To maintain its leadership in market technology, the NASD broke ground in 1996 for the construction of a state-of-the-art, \$33 million expansion of the Nasdaq data center located in Trumbull, Connecticut. One of the objectives in building this addition, two-and-a-half times larger than the current facility, is to increase Nasdaq trading capacity substantially as the 21st century approaches.

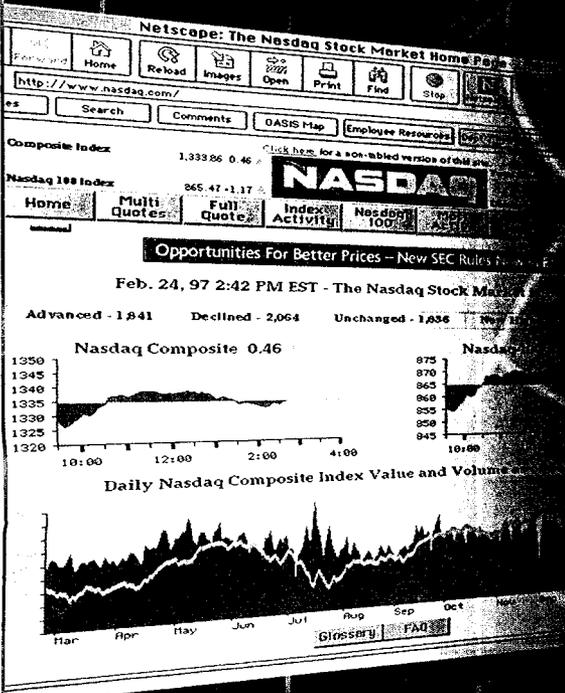


GROWTH

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intel

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Bid 108.1

Ask 108.3

108

Total
ASK



A Global Market for Growth Companies

Capital-Raising Potential

The fastest growing stock market in the United States, The Nasdaq Stock Market has drawn the attention of companies and investors the world over. During the last 10 years (1987-1996), annual share volume increased 264 percent to 138.1 billion, the record for any U.S. securities market, while market capitalization expanded 343 percent to \$1.52 trillion. The number of trades executed in the Nasdaq National Market grew 392 percent to over 79 million a year.

For companies, this growth signifies a market that offers them substantial capital-raising potential. Over the past 10 years, 3,691 companies have gone public on the Nasdaq market, raising \$101.3 billion. In secondary public offerings, companies raised an additional \$102.2 billion.

Companies headquartered outside of the United States also take advantage of the Nasdaq market's capital-raising potential. For many years Nasdaq has listed the shares of more foreign-based companies than any other U.S. stock market. The number of foreign securities listed on Nasdaq grew to 318 in 1996, with an additional 142 as American Depositary Receipts.

Over the past few years, a number of foreign companies have, in fact, chosen Nasdaq as their primary market, a trend on the rise. In Europe and Israel, for instance, some 64 companies chose to go public on Nasdaq rather than on their home market.

What drives the growth of Nasdaq is the phenomenal growth of the companies that list on this market. A recent study conducted by Cognetics, Inc., found that, from January 1990 through June 1994, Nasdaq companies were responsible for creating one in six new jobs in the United States, though they represented less than 1 percent of all U.S. businesses. Some 51 percent of Nasdaq companies were growing at an "explosive" rate (45 percent or greater growth in employees during study period) compared to a national average of 3 percent.

Investors who have looked to the Nasdaq market for growth companies of this caliber have, in turn, been amply rewarded. During the past decade, the Nasdaq CompositeSM Index increased over 290 percent. The Nasdaq-100 Index[®] grew 426 percent during the same period of time and has risen 42.5 percent in each of the past two years.

Structured for Growth

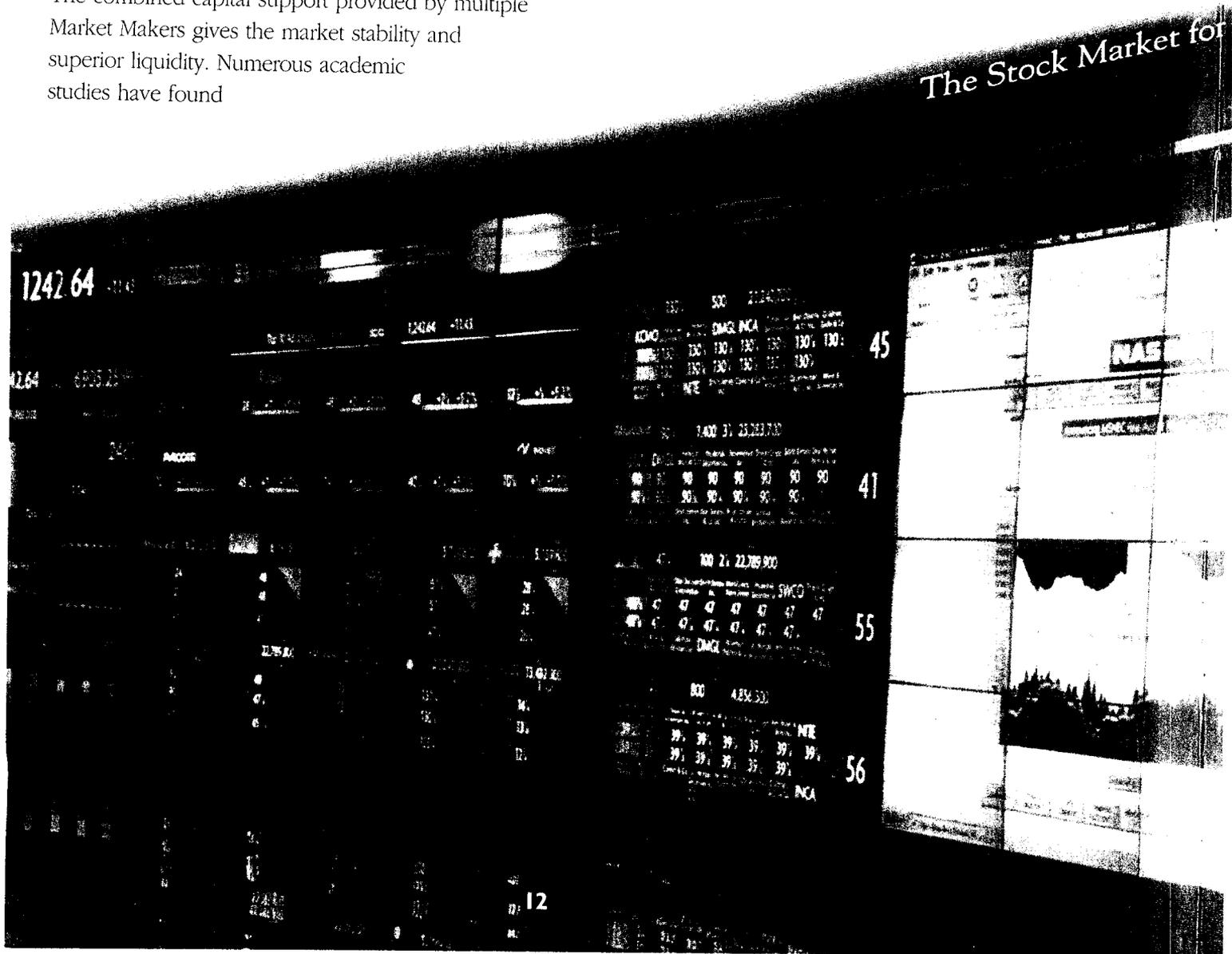
A system of multiple Market Makers serves as Nasdaq's foundation. Nasdaq Market Makers make a fundamental commitment to the success of the shares they trade beyond that of any other market. In addition to strong trading support, their sponsorship activities give Nasdaq stocks maximum visibility to create investor interest.

Each Nasdaq company has, on average, 10 Market Makers that commit their capital to support the trading of Nasdaq shares. In aggregate, this capital commitment provides substantial market depth and continuous trading opportunities for investors.

The combined capital support provided by multiple Market Makers gives the market stability and superior liquidity. Numerous academic studies have found

that it generally takes a much higher dollar volume of trading to cause a price change on Nasdaq.

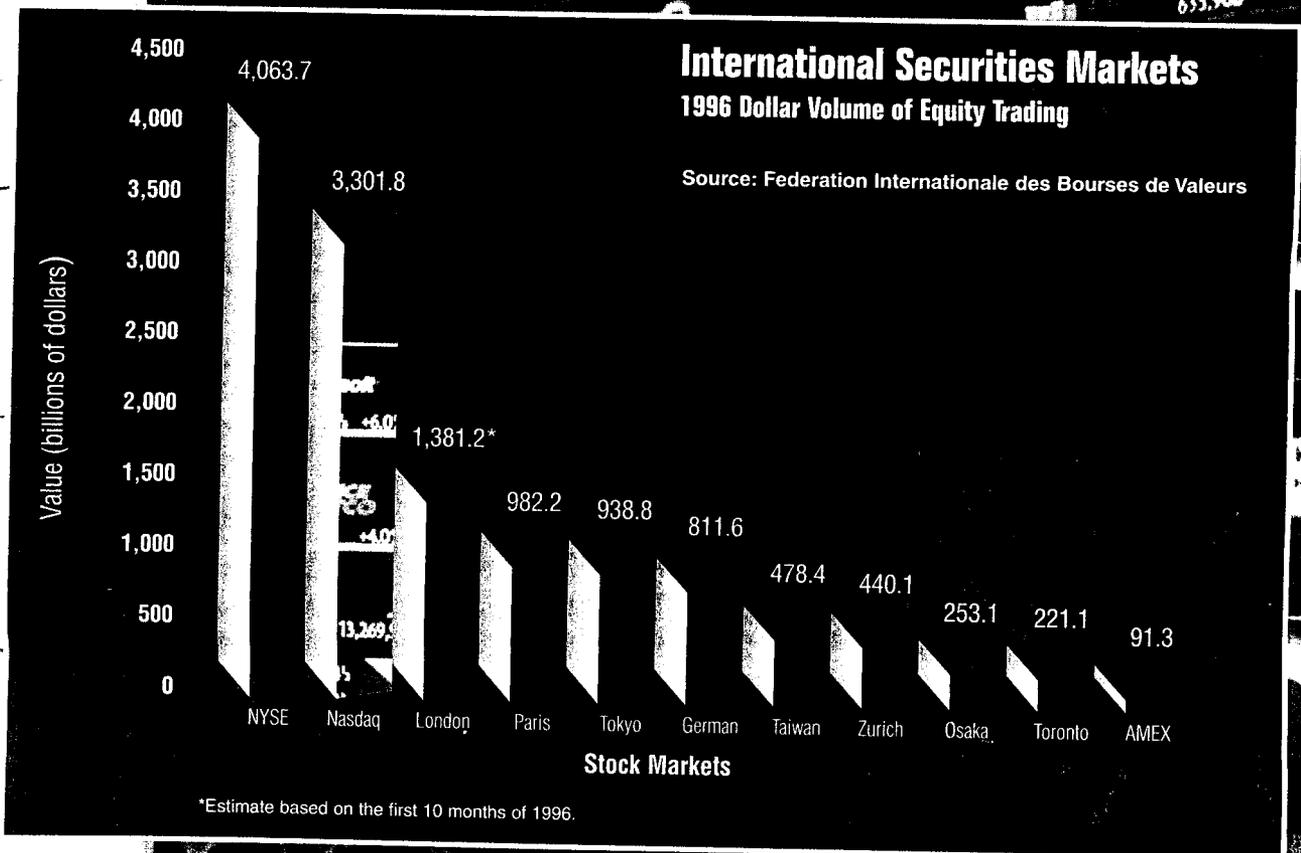
As critical as trading support is for a stock, the multiple-Market-Maker structure of Nasdaq offers another dimension of service beyond that of other kinds of markets—sponsorship. Market Makers write and distribute research reports to support their retail broker network and institutional sales force. Through these efforts, Nasdaq Market Makers increase visibility and generate demand for the stocks of the companies they trade.

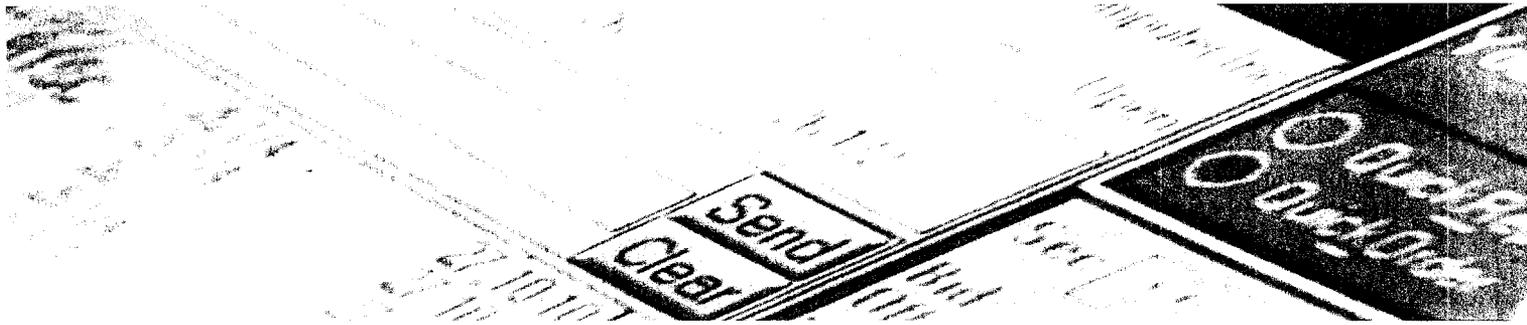


With the advantages of multiple Market Makers and an electronic, screen-based system that links all trading in Nasdaq securities throughout the world and permits participation anywhere, Nasdaq is often described as the market of the future. Testimony to this fact is the number of markets around the world that have adopted screen-based trading. According to the Federation Internationale des Bourses de Valeurs, Paris, of the 45 developed stock markets in the

world today, only three still rely exclusively on a trading floor. The rest either are entirely screen-based (28) or employ screen-based trading to supplement transactions done on a trading floor (14).

the Next 100 Years





Market Quality

The Nasdaq Stock Market is committed to being the fairest, most effective, and most efficient market in the world. We recognize that there are millions of investors—and millions more to come—who look to securities investing to create wealth that will be needed to finance education, achieve financial independence, and provide for retirement in a new, knowledge-driven economy.

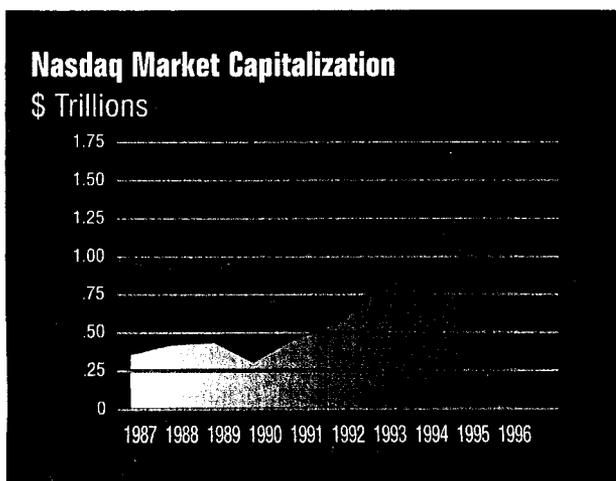
Nowhere is this commitment more evident than in Nasdaq's continuing effort to improve market quality. Nasdaq has a long history of applying the most advanced technology to the trading of securities to enhance access and competitive pricing. For investors, a quality market is one in which all investors, both individual and institutional, can compete on an equal footing for the best price when buying or selling stock.

Nasdaq took a major step to improve the market for investors when, in 1997, it used advanced technology to implement the new SEC Order Handling Rules. Working closely with the SEC, Nasdaq introduced structural changes that improved prices for investors.

Nasdaq has empowered investors as never before. Today customers' orders participate directly with those of Market Makers. Specifically, investors' limit orders are now displayed by Market Makers in their quotes when they are priced better than the quote of the Market Maker receiving the order. This gives investor limit orders greater visibility, making them more likely to be executed.

Through Nasdaq technology and the new SEC rules, the world of proprietary institutional trading systems has also been opened to all investors. Market Makers now display their most competitive quotes publicly as well as over proprietary electronic trading systems. This enables investors to trade at the best prices that Market Makers offer.

Nasdaq will seek regulatory approval for a single, integrated order delivery and execution trading system to automate the features of the new SEC Order Handling Rules to make their implementation even more efficient for investors and more convenient for other market participants. This advanced trading system will allow investors to reach the best price, whether displayed by a Market Maker or private trading system.





To compete in today's global economy, companies need prompt and efficient access to capital. They must constantly stay ahead of the curve—putting their capital to work to bring new products to market—or fall behind their more nimble international competitors. In today's information-

driven economy, companies require capital to implement the latest technology to create razor-edge efficiencies and instantaneous communication.

The Nasdaq Stock Market is a leading economic engine of capital formation. Over 85 percent of newly public domestic companies list their shares on Nasdaq, and a growing number of international growth companies are bypassing their home markets, electing a U.S. distribution and a Nasdaq listing as the preferred choice for raising capital. The reasons for this are clear.

First, Nasdaq is a securities market that is in tune with the times. It capitalizes on computers and telecommunications and electronic networks to gather and provide market information in real time to investors, broker/dealers, issuers, regulators, and other constituents around the world. Many technology companies list on Nasdaq because they relate well to a market that is itself based on technology.

Second, The Nasdaq Stock Market employs a system of competing Market Makers, securities firms that

openly compete with one another, on-line, for investor orders. It is a system that works and works well because it is efficient, timely, and competitive—the average Nasdaq company has 10 Market Makers working for it. Also, the combined capital of multiple Market Makers brings tremendous depth and liquidity to the market in a security. The sponsorship that Market Makers provide by linking issuers with investors through their retail distribution networks and research reports helps a security compete with thousands of other financial products for investor interest.

For Microsoft, The Nasdaq Stock Market has proven to be an effective market in which to have our stock trade. Nasdaq has established a reputation for growth around the world and is associated with growth companies, the kind of "company" we like to keep. Since going public on Nasdaq in 1986, our market capitalization has grown to well over \$100 billion.

A product of the Information Age, Nasdaq serves as a model for emerging stock markets around the world that want to fit in with the 21st century. Nasdaq is, in fact, built out of the advanced technology products of many of the companies whose stock is traded on it—companies, I like to think, that are helping to build the future.

Microsoft has traded its common stock on the Nasdaq market ever since our initial public offering as well as our recently issued preferred stock. Speaking from experience, I know Nasdaq has served us well.

*Michael W. Brown
Chief Financial Officer
Microsoft Corporation*



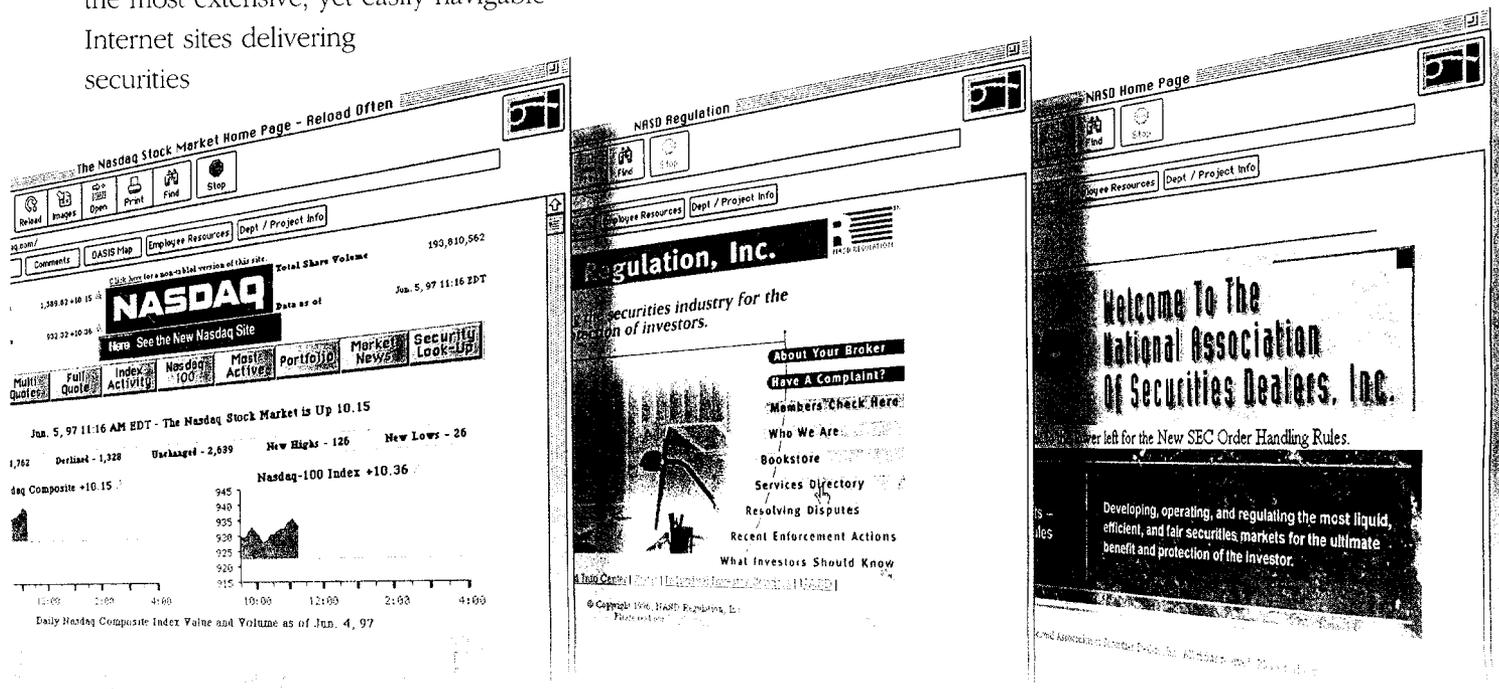
Using Technology to Inform Investors

Making trading information accessible to all market participants quickly and completely is Nasdaq's core business. Built totally out of telecommunications networks and computers, Nasdaq's Information Age technologies provide the fastest possible transmission of market information. Transaction and volume information is disseminated instantaneously for the entire market.

Recently Nasdaq used advanced technology to increase significantly the level of market information available to the individual investor. Nasdaq applied the most sophisticated Web development techniques and supporting technology to create one of the most extensive, yet easily navigable Internet sites delivering securities

information. Popular since its inception, the Nasdaq World Wide Web site (www.nasdaq.com) is currently one of the most active electronic information centers for investors in the world.

Nasdaq launched its Internet site to provide timely, institutional-quality market information to the general public. The site offers stock quotes, index values, and the latest wire service company and business news stories. It also features a free portfolio tracking service to enable investors to construct and follow the performance of a portfolio of Nasdaq, New York Stock Exchange, and American Stock Exchange securities on the Nasdaq Web site.





Market Integrity

An honest market is important to both investors and companies. To promote market integrity, Nasdaq works closely with its affiliate, NASD Regulation, to maintain effective surveillance and a rigorous examination and enforcement program.

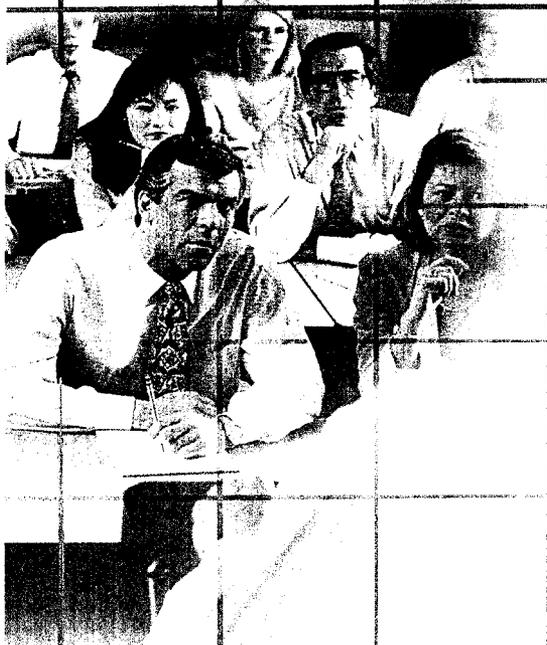
Nasdaq requires its listed companies to meet an increasingly demanding set of initial listing and maintenance standards, including financial criteria pertaining to assets and earnings, trading criteria relating to public float and share price, and corporate governance criteria.

To enhance market integrity, Nasdaq recently boosted the financial and minimum price criteria required for a company to begin or continue trading on its market. Nasdaq also extended its Nasdaq National Market corporate governance requirements to The Nasdaq SmallCap MarketSM companies.

To strengthen enforcement of companies' compliance with Nasdaq's listing and maintenance standards, Nasdaq recently created a new unit dedicated to examining the accuracy of pertinent information that corporations report.



Education



Investor Protection

FAIR

ENFORCEMENT

Regulating the securities industry for the benefit and protection of investors.

SEC | Nat'l Fraud Info Center |

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WHAT'S HOT

NASD REGULATION



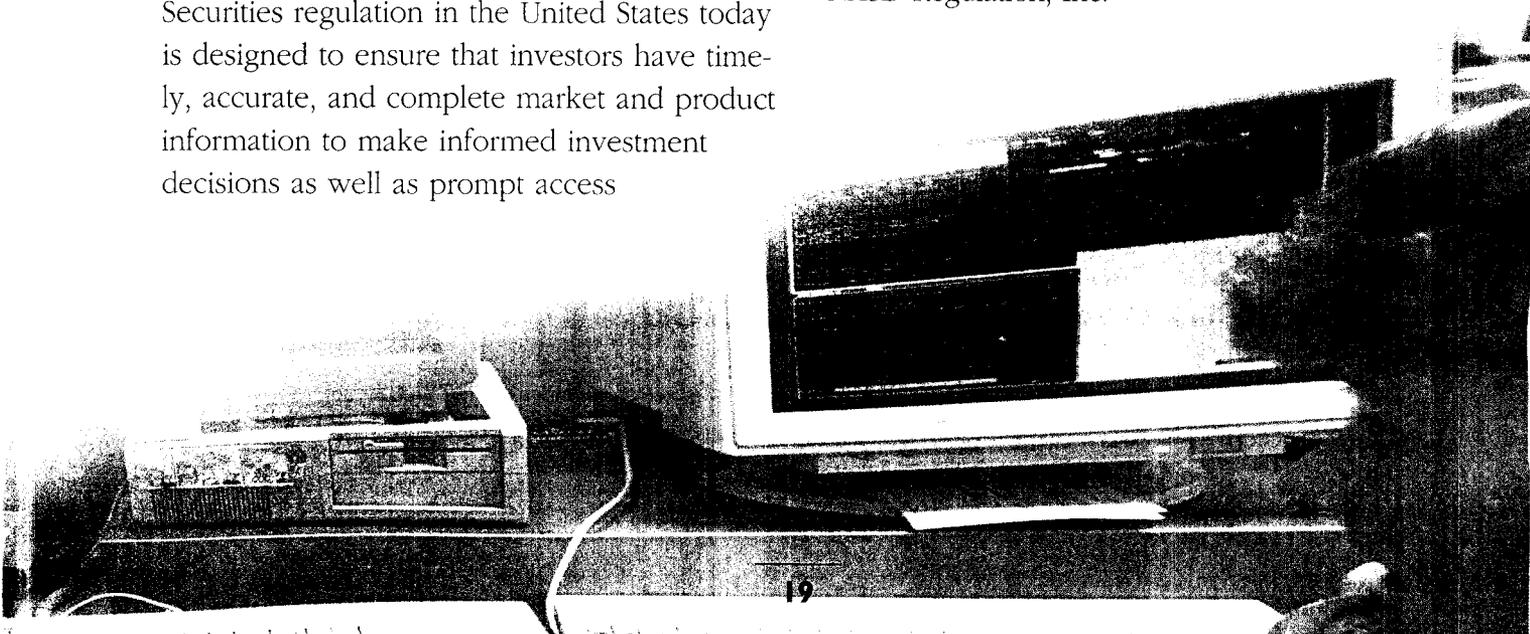
Fair Markets Through Effective Regulation

Enhancing Markets Through Regulation

Regulation makes a valuable contribution to the quality of the markets Nasdaq operates and to the securities industry in general by fostering fair and equitable competition for capital for all participants. Regulation facilitates capital formation by giving investors confidence to enter the market and invest their money.

Securities regulation in the United States today is designed to ensure that investors have timely, accurate, and complete market and product information to make informed investment decisions as well as prompt access

to the marketplace for the best execution of their orders. Regulation also protects the interests of investors by monitoring business practices and trading activity for fair dealing and by swiftly detecting and disciplining participants who violate the rules. The NASD carries out these regulatory responsibilities through its subsidiary, NASD Regulation, Inc.





Setting and Enforcing High Standards

For over 50 years, the NASD has set and enforced high standards of professional conduct in the U.S. securities industry. According to SEC statistics, in each of the past five years, the NASD has brought twice as many disciplinary actions against securities firms and their professionals as all other U.S. self-regulatory organizations combined.

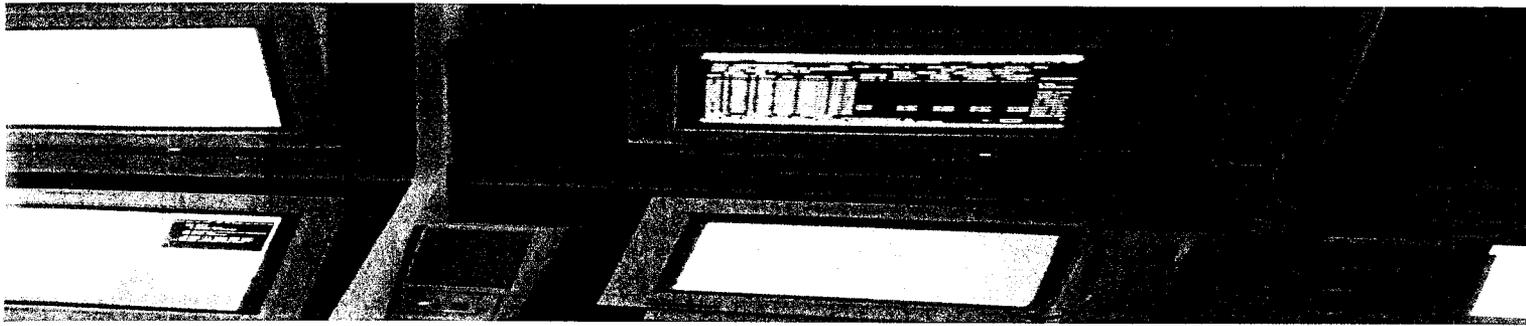
NASD Regulation writes rules to protect the public and obtains broad comment on those rules, from both industry and non-industry. NASD Regulation responds to more than 5,000 customer complaints annually, examines over 3,000 firms, handles more than 5,000 arbitration cases, teaches compliance to the industry, provides continuing education, and administers more than 260,000 qualification examinations.

Due to the scope of the NASD's regulatory responsibilities and the breadth of its membership, the U.S. Congress has repeatedly broadened the NASD's regula-

tory mandate. Over the years, these additional responsibilities have included the regulation of the municipal securities activities of broker/dealers and, more recently, member firms' activities in government securities. As part of a regulatory program for government securities, during the past year the NASD introduced a new qualification examination for the sale of these issues.

NASD Regulation has strengthened its enforcement program as the securities industry has grown. Regulatory personnel increased 9 percent and disciplinary actions brought by NASD Regulation are up 12 percent over last year. Also, NASD Regulation has recently proposed expanding its Public Disclosure Program—which makes available, for investor protection, a wide range of employment, criminal, civil-judgment, disciplinary, and arbitration information on brokers—to include, among other things, pending customer complaints and arbitrations.





Redefining Self-Regulation

The success of securities regulation in the United States owes much to self-regulatory organizations like the NASD that enable industry professionals to participate in formulating rules of fair business practice and market operation and in promoting compliance with those rules as well as securities laws.

In an industry that innovates quickly, whose products and services can be technically complex, the participation of securities professionals is important. Because of their day-to-day involvement in the securities business, securities practitioners are in a position to provide reliable information and expert insight. From experience, they help identify new products or services requiring special regulation, current business practices calling for revised rules, and what regulatory approaches will be most effective.

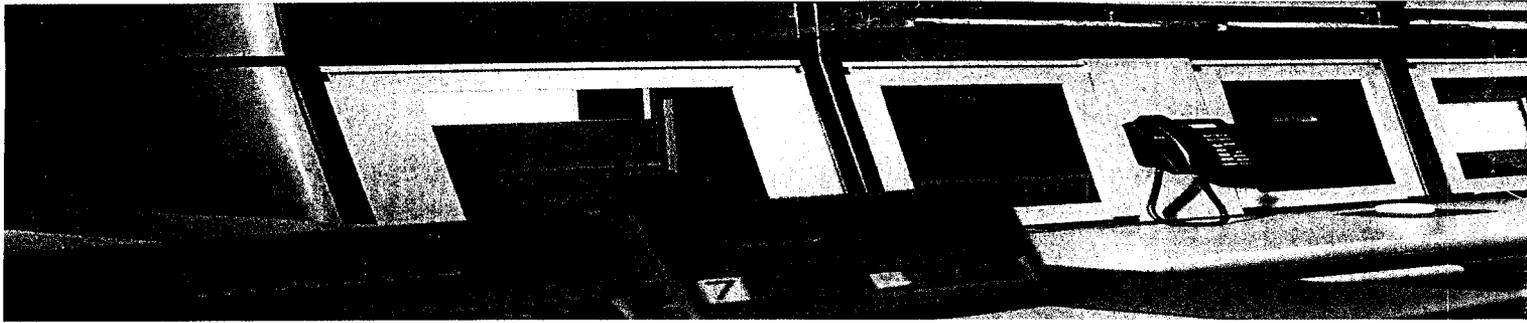
Self-regulation works well because of the ethical commitment and economic interest that industry professionals have in effective regulation and because of effective SEC oversight. Securities professionals want their industry to enjoy a reputation for fair dealing, for its very future depends upon customer satisfaction and repeat business.

To make the regulatory system even more effective in the United States as we approach a new century, the NASD is making a major additional investment in self-regulation. What will not change is the NASD's reliance on the participation

of hundreds of industry volunteers who serve on the boards of the organization and its advisory and disciplinary committees. The industry's own expertise and sense of fairness have contributed enormously in helping create rules that protect investors and in achieving a high level of compliance with those rules.

While industry participation in the process is vital to the success of self-regulation, the NASD has taken steps to balance this industry voice with greater public representation and with other professional expertise. In particular, the NASD Board of Governors is now composed of a majority of non-industry representatives.

The NASD's regulatory subsidiary, NASD Regulation, has also strengthened the role of public participation in the decision-making process by soliciting public comment on significant proposed rules before they are filed with the SEC. In addition, to better balance the enforcement process, professional staff will determine when to institute a disciplinary proceeding. Also, staff members with legal expertise will serve as hearing officers and chair disciplinary panels with two other members from the industry.

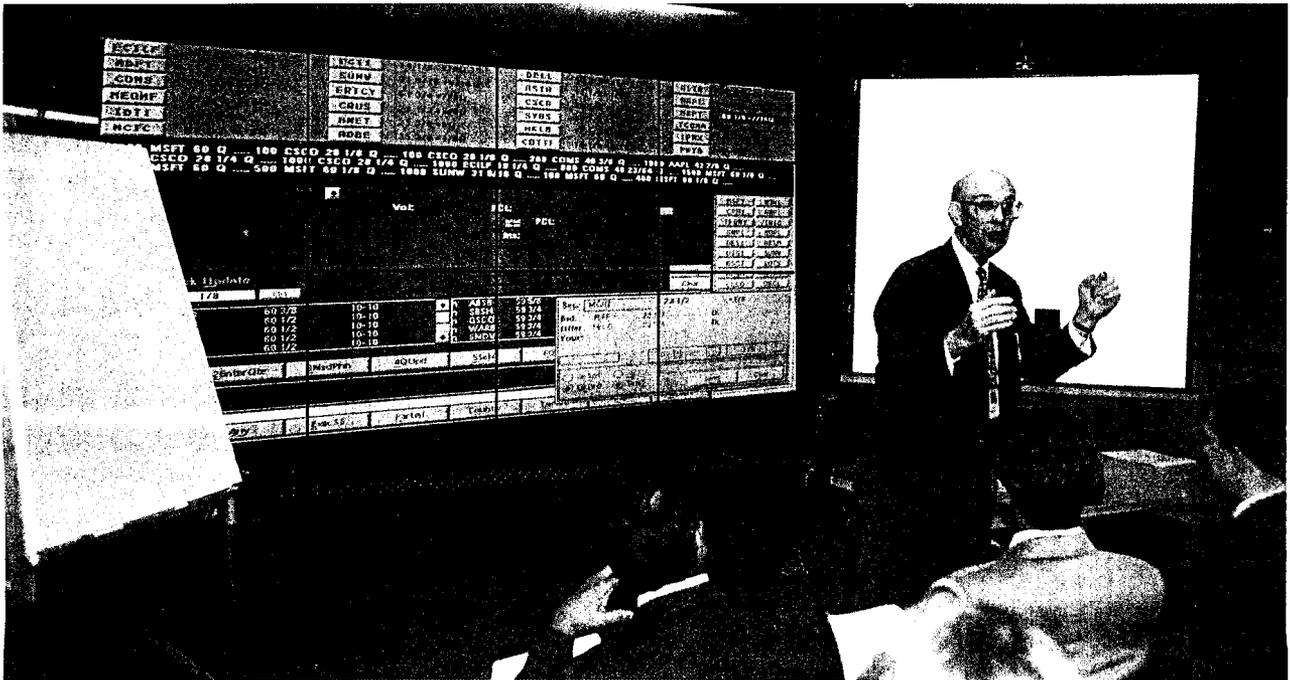


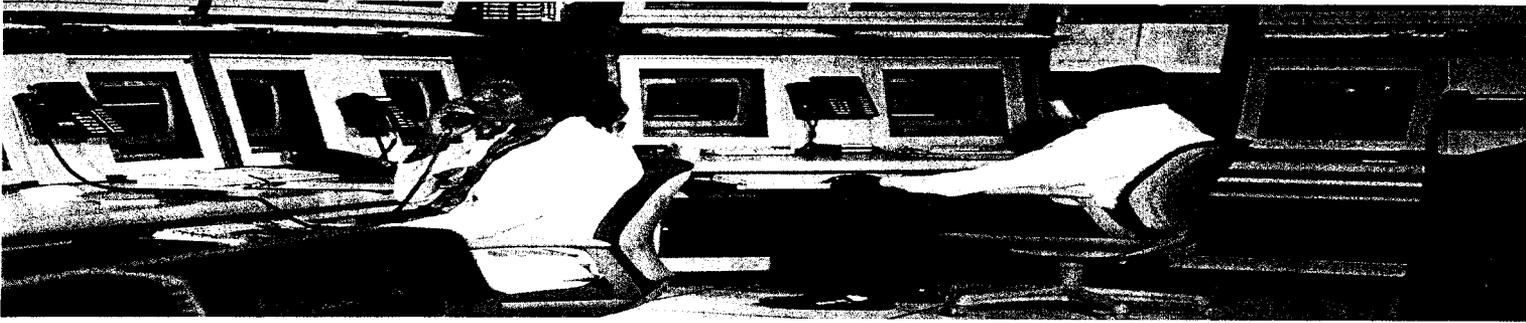
Reaching Out to Investors

NASD Regulation believes that one of the most effective ways to protect individual investors is to involve them more in the regulatory process and provide them with information essential to making sound decisions about brokers and investment alternatives. To do this, NASD Regulation is continually enhancing its investor outreach program.

The foundation of this program is the NASD Regulation Web site (www.nasdr.com), providing investors with timely regulatory information, and the on-line ability to request disciplinary histories of brokers, file complaints, and comment on proposed rules.

The NASD Regulation Web site is complemented by the NASD's Individual Investor Services site (www.investor.nasd.com), which offers training on investment basics, guidance on working with a broker, market research, a financial calculator to analyze investment performance, and a calendar of investor events. In addition, the NASD publishes an investor newsletter, makes presentations and provides information at investor forums, and airs public service announcements on investor protection over television and radio in English and Spanish.





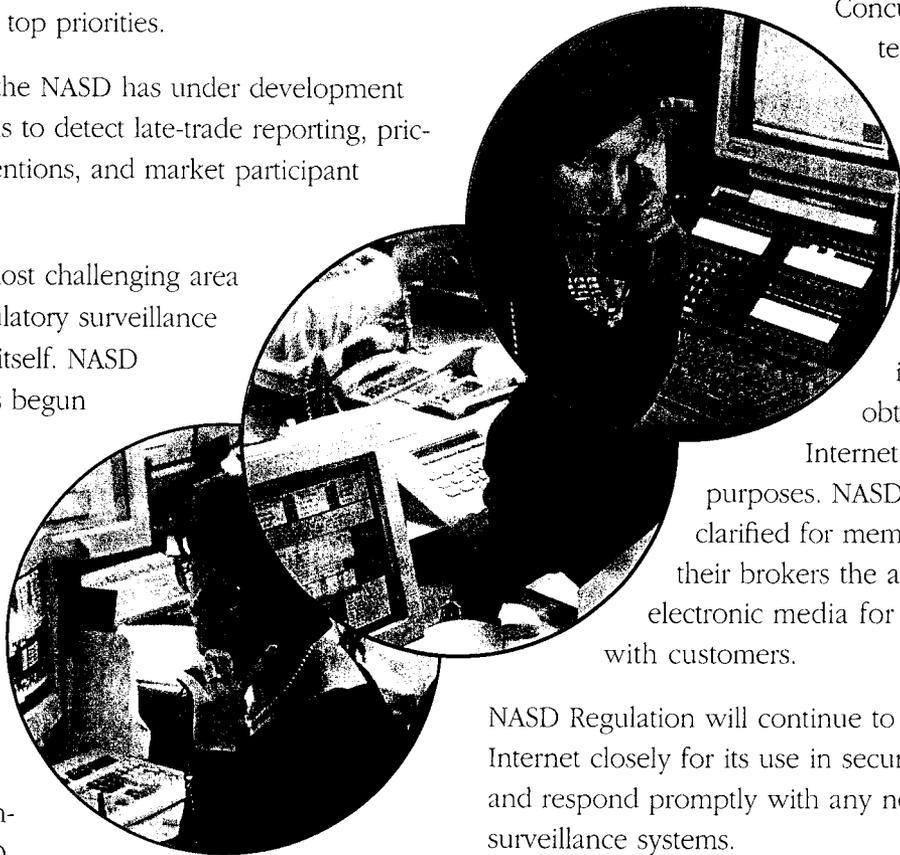
Advantages and Challenges of Technology

The development of technological systems to enhance regulatory capabilities using the latest information technologies will continue to be one of the NASD's top priorities.

For instance, the NASD has under development several systems to detect late-trade reporting, pricing/size conventions, and market participant coordination.

Perhaps the most challenging area for future regulatory surveillance is cyberspace itself. NASD Regulation has begun surveilling the World Wide Web for on-line investment scams and violative conduct by its members and others. In the coming year, NASD Regulation will implement an automated system that will greatly increase the range, speed, and early warning capabilities of our surveillance. The field examination program will also be expanded

to provide greater coverage of members' use of the Internet in their businesses.



Concurrent to this technology initiative, NASD Regulation began an investor education program regarding the use of information obtained from the Internet for investment purposes. NASD Regulation also clarified for member firms and their brokers the appropriate use of electronic media for communicating with customers.

NASD Regulation will continue to monitor the Internet closely for its use in securities investing and respond promptly with any necessary rules or surveillance systems.

In all its activities, NASD Regulation will fulfill its commitment to investor protection. It will regulate effectively and will be responsive to the needs of investors.

NASD Board of Governors

Frank G. Zarb
*Chairman, Chief Executive Officer
and President*
National Association of Securities
Dealers, Inc.

Nancy Kassebaum Baker
Washington, DC

John H. Biggs
Teachers Insurance Annuity
Association/College Retirement
Equity Fund

Elaine L. Chao
The Heritage Foundation

E. David Coolidge, III
William Blair & Company, L.L.C.

James Dimon
Smith Barney, Inc.

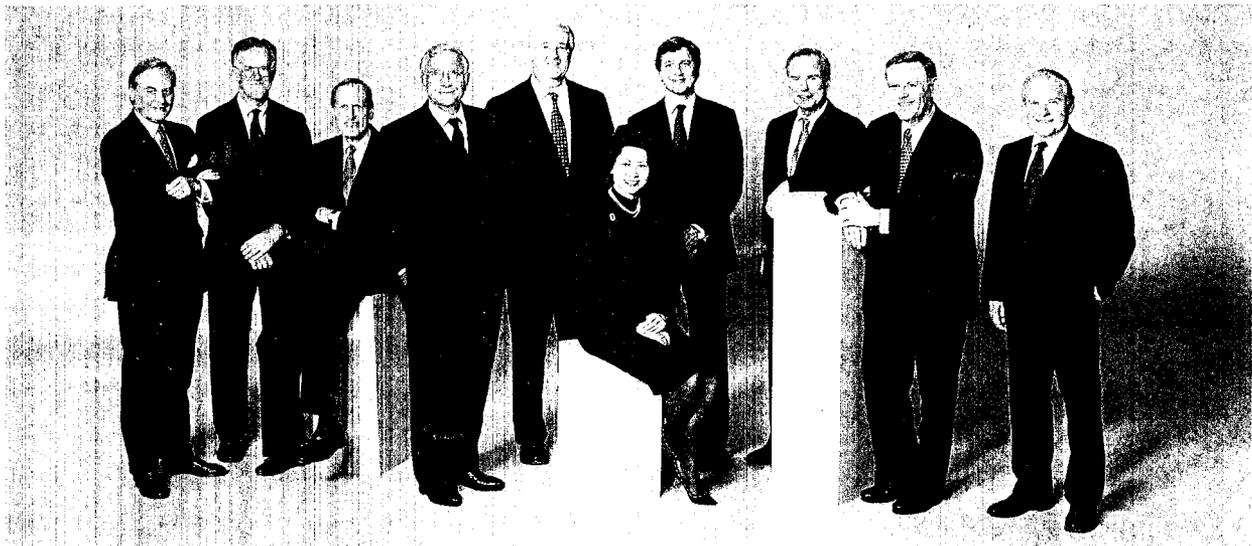
Charles B. Johnson
Franklin Resources, Inc.

Donald J. Kirk
Columbia University
Graduate School of Business

Bert C. Roberts, Jr.
MCI Communications Corporation

Daniel P. Tully
Merrill Lynch & Co., Inc. (retired)

R. Brian Williamson
Genard Group Plc



From Left to Right: R. Brian Williamson; John H. Biggs; E. David Coolidge, III; Frank G. Zarb; Daniel P. Tully; Elaine L. Chao; James Dimon; Donald J. Kirk; Bert C. Roberts, Jr.; Charles B. Johnson. Not present for photo: Nancy Kassebaum Baker.

Main NASD Offices

**National Association
of Securities Dealers, Inc.**
1735 K Street, NW
Washington, DC 20006-1500
Telephone: (202) 728-8000
Inquiries: (301) 590-6500
Fax: (202) 293-6260

NASD Financial Center
33 Whitehall Street
New York, NY 10004-2193
Telephone: (212) 858-4000
Fax: (212) 509-8436

NASD/NASD Regulation, Inc.
1390 Piccard Drive
Rockville, MD 20850
Telephone: (301) 590-6500

NASD
5 Choke Cherry Road
Rockville, MD 20850
Telephone: (301) 417-6868
Fax: (301) 417-6540

NASD Operations Center
9513 Key West Avenue
Rockville, MD 20850-3389
Telephone: (301) 590-6500
Fax: (301) 590-6705

**NASD/The Nasdaq Stock
Market, Inc.**
15201 Diamondback Dr.
Rockville, MD 20850
Telephone: (301) 590-6500

The Nasdaq Stock Market, Inc.
1735 K Street, NW
Washington, DC 20006-1500
Telephone: (202) 496-2500
Fax: (202) 496-2696

The Nasdaq Stock Market, Inc.
33 Whitehall Street
New York, NY 10004-2193
Telephone: (212) 858-4000
Fax: (212) 858-3980

The Nasdaq Stock Market, Inc.
2500 Sandhill Road
Suite 220
Menlo Park, CA 94025
Telephone: (415) 233-2000
Fax: (415) 233-2099

Nasdaq International, Inc.
Durrant House
8/13 Chiswell Street
London EC1Y 4XY
United Kingdom
Telephone:
(011-44-171) 825-5501
Fax: (011-44-171) 374-4488

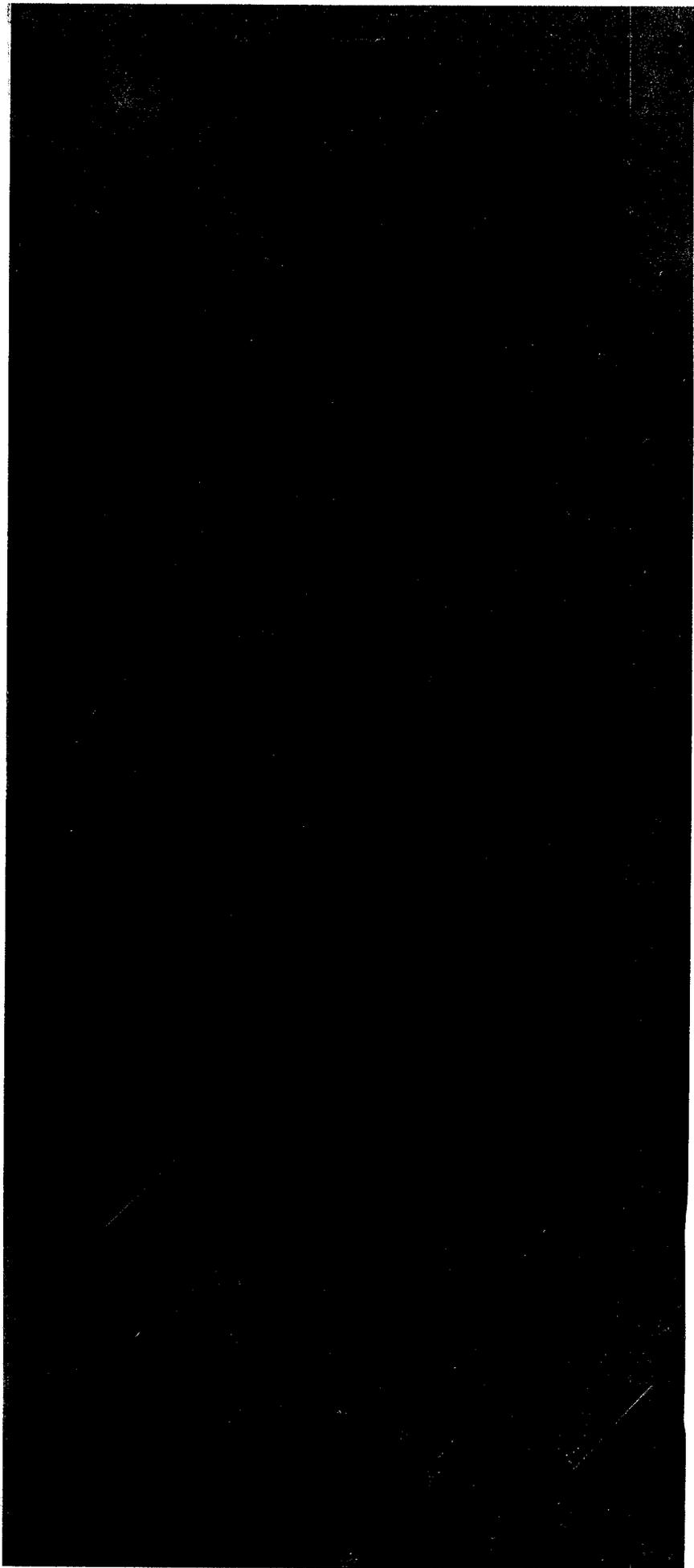
Nasdaq Data Center
80 Merritt Boulevard
Trumbull, CT 06611
Telephone: (203) 385-4500
Fax: (203) 385-6503

World Wide Web Internet Sites

www.nasd.com
www.nasdaq.com

www.nasdr.com
www.investor.nasd.com

www.nasdaqnews.com
www.nimi.com



NASD[®]

1735 K Street, NW
Washington, DC 20006-1500
Telephone: (202) 728-8000
Inquiries: (301) 590-6500
Fax: (202) 293-6260

www.nasd.com

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Financial
Statements

National Association of
Securities Dealers, Inc.

1996 Consolidated Financial Statements

Management Report on Financial Operations

The National Association of Securities Dealers, Inc. (NASD[®]) and its wholly owned subsidiaries experienced the best financial year in their history in 1996. Consolidated income before provision for income taxes reached a record \$82.7 million, while net income of \$54.8 million also set a new high. Both amounts more than tripled their levels from 1995.

Record revenues of \$556.1 million were achieved in 1996, an increase of 27 percent over the 1995 total of \$437.6 million. Revenues associated with The Nasdaq Stock Market, Inc. (Nasdaq[®]) again led the growth trend, accounting for 60 percent or \$70 million of the increase. Specifically, the sale of market information grew by approximately \$30 million as the population of professional retail, dealer, and institutional Nasdaq subscribers rose over 15 percent to a record 343,900, and Nasdaq Workstation II[™] service recipients benefited from value-added services and significantly increased capacity. Also, Nasdaq trading and comparison service fees jumped over \$20 million as average trading volume hit an historical high of 544 million shares per day or 35.5 percent above the year earlier period. Nasdaq issuer fees surged \$19 million as the number of listed companies grew by 434 to an all-time high of 5,556 with a total market capitalization of \$1.5 trillion. 1996 also saw Nasdaq derive higher revenue by attracting a pinnacle of 655 initial public offerings which, along with a landmark number of secondary offerings, resulted in a record capital formation of \$51.8 billion for Nasdaq companies. On the regulatory side, member assessments climbed \$15.4 million, fueled by the sharp rise in member firm revenues in 1995 (basis for 1996 NASD revenue). Registration and qualification activity income moved up \$12.8 million from a 13 percent favorable trend in qualification exam enrollments, the first full year of the continuing education training program and targeted higher fee rates. Regulatory transaction fees strengthened by \$8.3 million or 35 percent, matching the volume surge in Nasdaq share trading volume.

The year 1996 was a landmark period in the NASD's history, marked by substantial change in its organization and governance structure, and implementation of tactical initiatives targeted at improvements in regulatory, market, and dispute resolution operations in response to several external reviews of the NASD. Despite these watershed changes, expense levels advanced just over one-half the rise in revenues, or a net of 15.3 percent. Of particular significance, in August 1996 the Securities and Exchange Commission concluded its two-year investigation of, and reached a settlement with, the NASD. As part of this settlement, the SEC acknowledged the NASD's commitment to spend \$100 million over the next five years to enhance its systems for market surveillance, including the development and implementation of an enhanced audit trail, and to increase its staffing in the areas of examination, surveillance, enforcement, and internal audit. As part of this commitment, staff resources were added in 1996 to address intensified efforts involving our member

regulation program and to maintain and enhance the organization's technology-based systems. Staff were also augmented to respond to organizational structure changes and dispute resolution service needs based on the independent studies of the NASD's operations.

Compensation costs were also boosted by incentive compensation reflective of the organization's achievement of its corporate goals for the year. The NASD's expanding cost base continues to be acutely driven by the impact of its technology investments. Specifically, heightened cost levels reflect the full-year cost impact of initiatives completed in 1995 to upgrade Nasdaq market systems and network capacities and reliability; the continued development of new market regulation systems, including the construction of the Order Audit Trail System[™], the first of its kind in any major market; the development of an assessment and plan to modify all continuing systems to be Year 2000 compliant; and the development of enhanced Nasdaq trading systems, including monumental changes to Nasdaq's quotation and execution facilities to incorporate customer limit orders, which were successfully implemented on January 20, 1997.

An important development in 1996 involved the execution of a long-term contract for outsourcing the administration of the NASD's qualification program, which is expected to generate considerable cost savings over its term. Finally, the robust financial results for 1996 have enabled a significantly higher contribution in the amount of \$5 million to The Nasdaq Stock Market Educational Foundation to promote its economic and capital market educational support grants.

Capital spending on property and equipment also reached a peak of \$74.3 million in 1996, marked by significant outlays for computer mainframe/server, facilities and client/desktop acquisitions in support of the growth of NASD's services. During 1996 Nasdaq embarked on a major expansion of its primary data center, scheduled for completion in 1997, to provide ample capacity for handling substantial escalation in transaction volumes.

Working capital of \$204.1 million, including the non-current portion of investments, expanded by \$22.9 million from the end of 1995. The organization's working capital position has declined only slightly from its peak at the end of 1993, despite capital investments of approximately \$197 million over the last three years. Nearly two-thirds of these outlays have involved technology assets which have been added to accommodate expanded systems capacity and applications, user and staff growth, as well as to enhance staff productivity. Continued prudent management of working capital, a key measure of the organization's liquidity, is essential to fund expected high levels of capital spending over the next several years as the NASD continues to respond to even higher capacity and related requirements.

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) and its subsidiaries. This responsibility includes the selection of accounting procedures and practices, which are in accordance with generally accepted accounting principles. The consolidated financial statements have been prepared in conformity with these procedures and practices applied on a consistent basis. These consolidated financial statements reflect informed judgments and estimates, that management believes to be reasonable, in the determination of certain data used in the accounting and reporting process.

The NASD maintains an effective system of internal accounting controls that is periodically modified and improved to correspond with changes in the NASD's operations. This system of internal controls is designed to provide assurance that the assets of the 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 the 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 the NASD's Internal Review Department. It is management's opinion that the system of internal control as of December 31, 1996, is effective

in providing reasonable assurance that the consolidated financial statements are free of material misstatement.

The Board of Governors of the NASD and Boards of Directors of its subsidiaries establish charters for their Audit and Finance Committees, as applicable, which monitor the accounting and financial operations of NASD and/or its subsidiaries through the review and discussion of periodic financial plans and current operational results; proposed changes, if any, in significant accounting policies; reports prepared by the NASD's independent auditors covering the basis of their engagement and an annual review of their independence; and all other financial or accounting matters. The Audit Committee and the Finance Committees (with the exception of the Presidents of the subsidiaries) consist exclusively of external governors/directors who have, in the opinion of the Boards of Governors/Directors, no association or relationship that would interfere with the exercise of independent judgment as committee members.

The NASD's independent auditors, Ernst & Young LLP, have conducted an audit in accordance with generally accepted auditing standards of the consolidated financial statements of the NASD for the years ended December 31, 1996 and 1995. Representatives of Ernst & Young LLP 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.

1996 Consolidated Financial Statements

Report of Ernst & Young LLP, Independent Auditors

Board of Governors
National Association of Securities Dealers, Inc.

We have audited the accompanying consolidated balance sheets of the National Association of Securities Dealers, Inc., as of December 31, 1996, and 1995, and the related consolidated statements of income and members' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the 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 consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the National Association of Securities Dealers, Inc., at December 31, 1996, and 1995, and the consolidated results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Ernst & Young LLP

Washington, DC
February 24, 1997

Audited Consolidated Financial Statements

Consolidated Balance Sheets

	December 31	
	1996	1995
<i>(In Thousands)</i>		
Assets		
Current assets:		
Cash and cash equivalents	\$ 37,193	\$ 19,476
Investments — current	74,762	67,059
Receivables and other current assets	63,699	51,555
Total current assets	175,654	138,090
Investments — non-current	192,076	171,563
Property and equipment:		
Land, buildings and improvements	61,761	47,652
Data processing equipment and software	174,242	153,888
Furniture, equipment and leasehold improvements	106,407	77,226
	342,410	278,766
Less accumulated depreciation and amortization	(165,374)	(134,067)
	177,036	144,699
Other assets	3,450	4,237
	\$ 548,216	\$ 458,589
Liabilities and Members' Equity		
Current liabilities:		
Accounts payable and accrued expenses	\$ 109,596	\$ 81,732
Deposits, refunds due and deferred revenue	54,007	46,700
Total current liabilities	163,603	128,432
Accrued pension costs	14,040	15,690
Other liabilities	8,840	7,581
Total liabilities	186,483	151,703
Members' equity	361,733	306,886
	\$ 548,216	\$ 458,589

See accompanying notes to consolidated financial statements.

Consolidated Statements of Income and Members' Equity

	Year ended December 31	
	1996	1995
	<i>(In Thousands)</i>	
Revenue		
Market information and transaction service fees	\$ 222,459	\$ 171,220
Nasdaq issuer fees	111,832	92,700
Member assessments	65,252	49,831
Registration and qualification fees	59,970	47,160
Regulatory fees and fines	31,859	23,557
Interest and other	29,525	26,552
Corporate finance fees	21,932	16,891
Arbitration fees	13,275	9,660
Total Revenue	<u>556,104</u>	<u>437,571</u>
Expenses		
Compensation	198,094	164,479
Professional and outside services	94,075	106,223
Computer operations and data communications	65,078	46,458
Depreciation and amortization	40,509	29,687
Publications, supplies and postage	20,238	18,862
Occupancy	19,579	17,281
Travel, meetings and training	19,464	17,761
Other	16,338	9,817
Total Expenses	<u>473,375</u>	<u>410,568</u>
Income before provision for income taxes	82,729	27,003
Provision for income taxes	<u>27,882</u>	<u>9,859</u>
Net income	54,847	17,144
Members' equity at beginning of year	<u>306,886</u>	<u>289,742</u>
Members' equity at end of year	<u>\$ 361,733</u>	<u>\$ 306,886</u>

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

	Year ended December 31	
	1996	1995
	<i>(In Thousands)</i>	
Net income	\$ 54,847	\$ 17,144
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	40,509	29,687
Gain on sale of property and equipment	(1,958)	—
Provision for deferred income taxes	1,038	5,763
Increase in receivables	(12,144)	(6,726)
(Increase) decrease in other assets	787	(186)
Increase in accounts payable and accrued expenses	27,864	22,469
(Decrease) increase in deposits and deferred revenue	7,307	(4,707)
Decrease in accrued pension and other liabilities	(1,429)	(4,855)
Net cash provided by operating activities	116,821	58,589
Investing activities		
Proceeds from redemptions of investments	127,960	50,749
Purchases of investments	(156,176)	(43,299)
Proceeds from sale of property and equipment	4,274	—
Purchases of property and equipment	(75,162)	(60,740)
Net cash used in investing activities	(99,104)	(53,290)
Increase in cash and cash equivalents	17,717	5,299
Cash and cash equivalents at beginning of year	19,476	14,177
Cash and cash equivalents at end of year	\$ 37,193	\$ 19,476

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of the National Association of Securities Dealers, Inc. (NASD) and its wholly owned subsidiaries (collectively "the Company"), including The Nasdaq Stock Market, Inc. (Nasdaq), NASD Regulation, Inc. (NASDRSM), Nasdaq International, Ltd. (Nasdaq International), Securities Dealers Insurance Company Ltd. (SDIC), and the Securities Dealers Risk Purchasing Group, Inc. (SDRP) after elimination of all significant intercompany transactions.

NASD is a membership association established to regulate the Nasdaq and the over-the-counter securities markets. Nasdaq owns and operates the domestic and international electronic Nasdaq quote and trade information system and provides national market facilities to benefit NASD members and investors in their pursuit of efficient execution of securities transactions and to help issuers reduce their cost of capital. The NASDR (incorporated on January 25, 1996) was created to assist the NASD in fulfilling its self-regulatory responsibilities as set forth in Section 15A of the Securities Exchange Act of 1934. Nasdaq International promotes the Nasdaq market worldwide. SDIC is a captive insurance company established to reinsure risks associated with the member fidelity bond program. SDRP is a risk purchasing group formed to make available professional liability insurance for NASD members.

As an association established to regulate the Nasdaq and the over-the-counter securities markets and provide information and trading services to market participants, the Company's receivables are concentrated with firms in the broker/dealer industry.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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.

Cash and Cash Equivalents

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

Investments

Management determines the appropriate classification of debt securities at the time of purchase and reevaluates such designation as of each balance sheet date. Debt securities are classified as held-to-maturity in accordance with the investment policy of the Company to hold securities to maturity. Investments are stated at amortized cost, adjusted for amortization of premium and accretion of discounts to maturity.

Property and Equipment

Property and equipment are recorded at cost. Equipment acquired under capital leases is recorded at the lower of fair market value or the present value of future lease payments. Depreciation and amortization are provided on the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized over the period of the applicable lease.

Software and Advertising 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. All other software development costs are charged to expense as incurred. The Company expenses advertising costs in the periods in which the costs are incurred.

Income Taxes

The NASD is a tax-exempt organization under the Internal Revenue Code (IRC) Section 501(c)(6). NASDR is currently in the process of applying for tax exempt status under IRC Section 501(c)(6). All other subsidiaries of the NASD are taxable entities. The provision for income taxes includes amounts currently payable and amounts deferred to or from other years as a result of differences in the timing of income or expenses for financial reporting and tax purposes.

Classification

Expenses totaling \$30,658,000 in 1995 related to the system technology migration and other 1995 amounts have been reclassified to their respective components for the 1996 presentation.

Notes to Consolidated Financial Statements

2. Investments

Investments are made in U.S. Treasury securities and obligations of U.S. Government-sponsored enterprises and are classified as held-to-maturity in accordance with the securities policy of the Company. Throughout the year, up to five percent of the investments may be classified as available-for-sale to satisfy cash management needs.

The amortized cost and estimated fair value of debt securities at December 31, by contractual maturity, are shown below (in thousands):

	1996		1995	
	Cost	Estimated Fair Value	Cost	Estimated Fair Value
Due in one year or less	\$ 74,762	\$ 74,885	\$ 67,059	\$ 67,599
Due after one year through five years	\$ 192,076	\$ 192,545	\$ 171,563	\$ 173,946
	<u>\$ 266,838</u>	<u>\$ 267,430</u>	<u>\$ 238,622</u>	<u>\$ 241,545</u>

The gross unrealized gains and (losses) of the investments at December 31, 1996, were \$1,275,000 and (\$683,000), respectively. The gross unrealized gains and (losses) at December 31, 1995, were \$3,056,000 and (\$133,000), respectively.

3. Leases

Furniture, equipment, and leasehold improvements include the following amounts relating to leases which have been capitalized. The initial terms of the capitalized leases are 60 months.

	December 31	
	1995	1996
	<i>(In Thousands)</i>	
Furniture, equipment, and leasehold improvements	\$ 1,765	\$ 3,371
Less: accumulated depreciation and amortization	382	1,271
	<u>\$ 1,383</u>	<u>\$ 2,100</u>

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 \$13,318,000 in 1996 and \$10,185,000 in 1995. Future minimum lease payments under noncancelable operating leases with initial or remaining terms of one year or more consisted of the following at December 31, 1996:

	Capital Leases	Operating Leases
	<i>(In Thousands)</i>	
Year ending December 31:		
1997	\$ 410	\$ 12,399
1998	410	11,531
1999	410	10,425
2000	374	10,022
2001	-	8,834
Remaining years	-	11,877
Total minimum lease payments	1,604	\$ 65,088
Less: amount representing interest	177	
Present value of net minimum lease payments	1,427	
Less: amount due in one year	333	
	<u>\$ 1,094</u>	

Notes to Consolidated Financial Statements

4. Income Taxes

The income tax provision includes the following amounts for the year ended December 31:

	1996	1995
	<i>(In Thousands)</i>	
Current income taxes:		
Federal	\$ 21,630	\$ 3,328
State	5,214	768
Total current income taxes	<u>26,844</u>	<u>4,096</u>
Deferred income taxes:		
Federal	865	4,802
State	173	961
Total deferred income taxes	<u>1,038</u>	<u>5,763</u>
Total provision for income taxes	<u>\$ 27,882</u>	<u>\$ 9,859</u>
Income taxes paid during the year	<u>\$ 25,133</u>	<u>\$ 6,891</u>

The effective tax rates for the taxable entities were 40 percent and 37 percent for 1996 and 1995, respectively.

Components of the net deferred tax liability consisted of the following as of December 31:

	1996	1995
	<i>(In Thousands)</i>	
Deferred tax assets:		
Deferred entry fees	\$ 2,624	\$ 1,275
Compensation and benefits	2,016	1,683
Other	356	826
Total deferred tax assets	<u>4,996</u>	<u>3,784</u>
Deferred tax liability:		
Depreciation	<u>(6,610)</u>	<u>(4,360)</u>
Net deferred tax liability	<u>\$ (1,614)</u>	<u>\$ (576)</u>

5. Retirement Benefits

The Company maintains a noncontributory, defined-benefit pension plan, along with other arrangements, for the benefit of eligible employees. The benefits are primarily based on years of service and the employees' average salary during the highest 60 consecutive months of employment.

The Company's funding policy is to contribute annually the minimum requirement under ERISA, subject to the full funding limitation imposed by the Internal Revenue Service. Contributions of \$6,533,000 and \$5,625,000 were required for 1996 and 1995, respectively.

The following table sets forth the plans' net pension cost for the years ended December 31:

	1996	1995
	<i>(In Thousands)</i>	
Service cost	\$ 6,301	\$ 5,029
Interest cost	5,364	5,004
Actual return on plan assets	(8,461)	(11,224)
Net deferral and amortization	<u>4,655</u>	<u>8,177</u>
Net pension cost	<u>\$ 7,859</u>	<u>\$ 6,986</u>

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

	1996	1995
	<i>(In Thousands)</i>	
Actuarial present value of benefit obligations:		
Accumulated benefit obligation, including vested benefits of \$40,748 in 1996 and \$37,452 in 1995	<u>\$ 47,471</u>	<u>\$ 43,934</u>
Projected benefit obligation	<u>\$ 81,288</u>	<u>\$ 73,993</u>
Less plan assets at fair value, principally common stocks, U.S. Government and agency bonds	56,054	45,921
	<u>25,234</u>	<u>28,072</u>
Unrecognized net asset	2,335	2,483
Unrecognized net gain (loss)	1,231	(5,278)
Prior service cost	(3,208)	(3,524)
Accrued pension cost	<u>25,592</u>	<u>21,753</u>
Less current portion	11,552	6,063
Long-term accrued pension cost	<u>\$ 14,040</u>	<u>\$ 15,690</u>

Notes to Consolidated Financial Statements

The weighted-average discount rate and rate of increase in future salary levels used in determining the actuarial present value of the projected benefit obligation were 7.75 percent and 5.5 percent, respectively, at December 31, 1996, and 7.25 percent and 5.5 percent, respectively, at December 31, 1995. The expected long-term rate of return on plan assets was 9 percent for 1996 and 1995. The unrecognized net asset is being recognized over 20 years, the average remaining service period of employees expected to receive benefits under the plan.

The Company also maintains a voluntary savings plan for employees. Employees are immediately eligible to make contributions to the plan and after one year of service are also eligible for an employer contribution match at an amount equal to 50 percent of the first 6 percent of eligible employee contributions. Eligible plan participants may also receive an additional discretionary match from the Company. Savings plan expense for the years 1996 and 1995 was \$5,064,000 and \$3,998,000, respectively. The expense included a discretionary match authorized by the Board of Governors totaling \$2,422,000 for 1996 and \$1,542,000 for 1995.

6. Commitments and Contingencies

There are certain legal proceedings pending against the Company. Management believes, based upon the opinion of counsel, that any liabilities or settlements arising from these proceedings will not have a material effect on the financial position or results of operations of the Company.

In 1996, the Company acquired adjacent land and initiated a major expansion of its data center facility in Trumbull, Connecticut. As of December 31, 1996, there were approximately \$23 million in construction contract commitments to complete the expansion.

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NASD[®]

1735 K Street, NW
Washington, DC 20006-1500
Telephone: (202) 728-8000
Inquiries: (301) 590-6500
Fax: (202) 293-6260

www.nasd.com

1996 Year in Review

National Association of
Securities Dealers, Inc.

1996 NASD Statistical Highlights

5,553 Member firms

60,151 Branch offices

534,989 Registered representatives

Information reflects data as of December 31, 1996.

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The Nasdaq Stock Market, Inc. Review of Operations, 1996

The Nasdaq Stock Market Breaks Performance Records

The Nasdaq Stock MarketSM, the nation's most active securities market, set a new share volume record in 1996, trading 138.1 billion shares, surpassing by 36 percent the previous record of 101.2 billion shares set in 1995. On average, 544 million shares were traded daily, compared with 401.1 million in 1995, an increase of 35 percent.

The Nasdaq CompositeSM Index reached an all-time high of 1316.27 on December 9, 1996, and closed the year at 1291.03. The Nasdaq Composite outperformed most major U.S. and world indexes, except for the Dow Jones Industrial Average. The Nasdaq Composite grew 22.7 percent for the year, compared with 26 percent for the Dow and 20.3 percent for the S&P 500 Index.

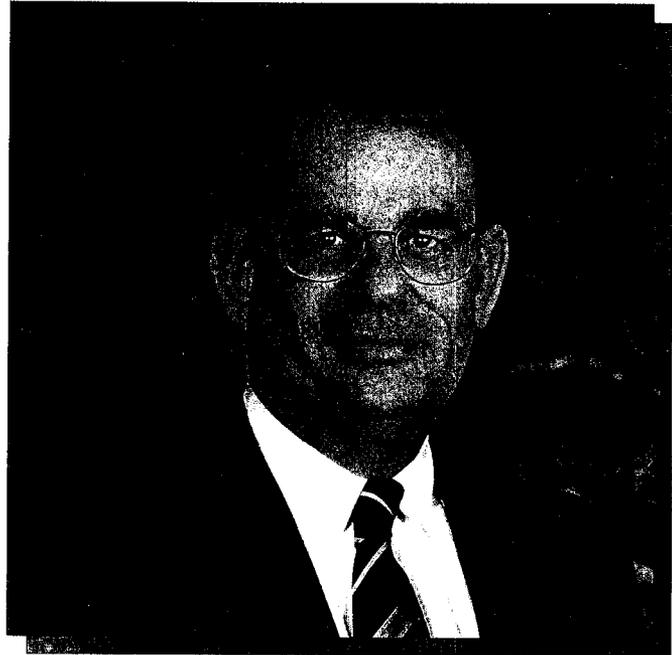
The Nasdaq-100[®] continued to be the fastest growing major index in the U.S. equities markets in 1996, up 42.5 percent, the same increase that it achieved in 1995. The Nasdaq[®] market's three best performing industry indexes during 1996 were Computer, up 41.7 percent, Other Finance, up 28.5 percent, and Bank, up 26.2 percent.

In 1996, 655 Nasdaq market initial public offerings (IPOs) raised \$24.1 billion, more than any other equities market in the U.S. This is a 37.6 percent increase in number of IPOs and a 44 percent increase in value of IPOs over 1995. The number of secondary public offerings also reached a new high in 1996: 428 secondary offerings (up 14.1 percent) and raised \$27.7 billion (up 11 percent). Almost half of the capital raised in the U.S. secondary markets was raised by companies listed on the Nasdaq market.

In 1996, 102 non-U.S. issues listed on the Nasdaq market, a 41 percent increase over the previous record of 71 set in 1995.

Public Representation Expanded in Nasdaq Governance

Acting on the recommendations of the Select Committee chaired by former Senator Warren Rudman, Nasdaq reconstituted its Board of Directors to balance its industry and non-industry representation. The non-industry directors represent a broad cross-section of individuals who have either held or currently hold senior positions in investor organizations, publicly traded companies, venture capital firms, government, consulting firms, and investment management companies. In 1996, the Board of The Nasdaq Stock Market, Inc., consisted of eight non-industry directors, six industry directors, and the Nasdaq president. This governing structure has provided the public ample representation in decisions affecting investors and the operation of Nasdaq markets.



Alfred R. Berkeley, III
President, The Nasdaq Stock Market, Inc.

Nasdaq Market Structure Changed to Implement New SEC Order Handling Rules

In recent years, The Nasdaq Stock Market has taken a number of steps to level the playing field for investors. It adopted rules that prohibit member firms from "trading ahead" of customer orders and it is developing an enhanced system, most recently a voluntary limit order file, to automate the matching of investors' limit orders and market orders and proposed companion rules to provide market-wide limit-order price protection.

The new Order Handling Rules adopted by the Securities and Exchange Commission (SEC) in 1996 increase market transparency and substantially improve the ability of investors to achieve best execution of their orders. It was for that reason that Nasdaq embraced the SEC rules and committed significant resources to preparing its systems to accommodate the most fundamental change to be made to Nasdaq in its 25-year history.

The rules, which went into effect in January 1997, provide for the interaction of the buying and selling interest of investors with Nasdaq Market Makers and independent electronic trading systems to achieve the best price for all investors. The rules require a Market Maker to incorporate customer limit orders into its quote, publicly displayed on terminals worldwide, if those orders improve upon the Market Maker's bid-ask price displayed on Nasdaq. In effect, the new rules allow customer limit orders to affect the price and size of quotes dis-

played by Market Makers. Moreover, if a Market Maker displays orders on a private trading network priced better than its bid-ask quote, such orders must be disseminated to all investors through Nasdaq. These rules, now being phased in, allow individuals as well as other market participants to access orders they could not previously see.

Because of their significant effect, Nasdaq is closely monitoring the impact of the rules on spreads, liquidity, immediacy of execution, and other elements of transaction costs, and the various operating aspects of Nasdaq.

Separately, the SEC approved Nasdaq's proposed rule to allow Market Makers and investors to place quotations in increments of 1/16 of a dollar for all securities listed on Nasdaq whose bid price is \$10 or above. Stocks under \$10 are already quoted in increments as small as 1/32.

Nasdaq believes the narrower quote increment will enhance market transparency and provide investors with improved opportunity for best execution. The change would also make it possible for Nasdaq to accommodate and reflect orders entered into Electronic Communication Networks (ECNs) that are priced narrower than the minimum quotation increment currently allowed for Nasdaq securities quoted at or above \$10.

Investor Information Provided on Nasdaq Internet Site

Nasdaq is leveling the playing field for the individual investor. In April 1996, Nasdaq launched a World Wide Web site (www.nasdaq.com) to provide individual investors easy access to institutional-quality information on the companies in its market. The Nasdaq Web Site is the only Web site with a direct link to a major stock market's trading system for pricing information.

Currently, the Nasdaq Web Site provides investors access to delayed quotes for Nasdaq, New York Stock Exchange and American Stock Exchange securities, and end-of-day pricing on over 6,000 mutual funds. Users can also use an advanced portfolio tracking feature to follow the performance of up to 300 securities, mutual funds, and options. Market activity is tracked graphically throughout the trading day for the major U.S. indices, including the Nasdaq Composite, Nasdaq-100 Index®, Dow Jones 30, S&P 500, New York Stock Exchange, and the American Stock Exchange.

Investors have access to more in-depth and timely information on all 5,600 Nasdaq-listed securities, encompassing on-line financial summary tear sheets, intraday and historical charting, company-specific news and press, on-line audio through MSNBC, and direct links to SEC EDGAR filings. Traffic to the Nasdaq Web Site has grown steadily since its launch, and with over four million hits per day, it is now one of the world's most active electronic information centers for investors.

To learn more about the informational needs of investors, Nasdaq became a partner in an exciting new investor education project with *Money* magazine, Microsoft Corporation, and Fidelity Investments. Nasdaq will be

providing the city of Elgin, Illinois with investor information resources, making the city, in effect, a living laboratory that will help determine investor information requirements and how best they can be met.

Nasdaq Developed State-Of-The-Art Information Service for Companies

In 1996, Nasdaq developed Nasdaq Online™, a Web-based service to deliver on-line market information. Nasdaq Online will serve as a tool for planning investor relations and provide insights into market behavior for Nasdaq-listed companies. This on-line service will help companies manage relationships with analysts, identify institutional investors, and provide board members with concise information quickly. It will also allow Nasdaq companies to see at a glance how their stock is trading, how competitors are trading, and whether the market is up or down at any given moment.

Listing and Maintenance Standards Upgraded for the Entire Nasdaq Market

To balance its role in facilitating legitimate capital formation for companies and provide the appropriate protection to public investors, Nasdaq has filed with the SEC a proposal to adjust its listing requirements for companies. It raised the financial standards for listing as well as continued listing and it extended its governance standards to all listed companies. The following is a short summary of the major changes:

Governance Standards. The Nasdaq SmallCap Market companies will be required to maintain the same governance standards as Nasdaq National Market companies, which include having two independent directors, an audit committee with a majority of independent directors, an annual shareholders meeting, and shareholder approval for large issuances of securities at below-market value.

Auditor Review. Auditors of all Nasdaq companies will be subject to peer review of their audit and accounting practices every three years by organizations such as the American Institute of Certified Public Accountants (AICPA) or the SEC Practice Session.

Financial Criteria. Key financial qualifications such as net tangible assets, pre-tax earnings, public float and market value of public float are increased by 50 percent or more for Nasdaq National Market companies and substantially more for Nasdaq SmallCap Market companies.

Minimum Price. All Nasdaq companies must trade at \$1 a share or more. Delisting proceedings will be initiated for any company whose stock price falls below \$1 for 30 days if that price does not close at or above \$1 for 10 consecutive days within a 90-day compliance period.

1996 Nasdaq Statistical Highlights

Annual share volume	138.1 billion
Annual dollar volume	\$3.3 trillion
Average daily share volume	543.7 million
Average daily dollar volume	\$13.0 billion
Market capitalization	\$1.52 trillion
Companies listed	5,556
Issues listed	6,384
Market Makers	541
Foreign securities and American Depositary Receipts (ADRs)	460
International share volume (foreigns and ADRs)	7.7 billion
International dollar volume (foreigns and ADRs)	\$125.2 billion
Number of initial public offerings	655
Value of initial public offerings	\$24.1 billion
Number of secondary public offerings	428
Value of secondary public offerings	\$27.7 billion

Information reflects data as of December 31, 1996.

Mutual Fund Quotation List Expanded to Include Small Mutual Funds

To provide investors with more comprehensive and timely information on mutual funds, Nasdaq increased the number of mutual funds and money market funds included on its Mutual Fund Quotation Service. The Service provides for the collection and dissemination of prices of mutual funds.

Nasdaq publishes two mutual fund lists daily. The News Media List, which is not being amended, contains the net asset values for approximately 5,500 funds. The Supplemental List, which is being expanded from 450 to 1,400 mutual fund and money market funds, is distributed to more than 280,000 quotation terminals worldwide. To qualify for this list, a mutual fund must have net assets at the time of application of \$10 million or more, or the fund must have been operating for two full years.

Next Phase of Nasdaq Trading Capacity Expansion Planned

In 1996, Nasdaq continued its technology migration, giving it an increased trading capacity of more than one billion shares daily. This

project represented the largest single technology conversion undertaken by a major stock market and was accomplished while the market continued normal operations handling record levels of volume.

In addition, work began on the next phase of Nasdaq trading system expansion as Nasdaq prepared to take further steps in a continuing process of anticipating and preparing to meet projected investor demand.

To maintain its leadership in market technology, Nasdaq broke ground in 1996 for the construction of a state-of-the-art, \$33 million data center expansion located in Trumbull, Connecticut. One of the objectives in building this addition, two-and-a-half times larger than the current facility, is to prepare for the technological demands of the marketplace as the 21st century approaches.

NIMI Undertook Major International Market Projects

Nasdaq International Market Initiatives, Inc. (NIMI), a separate unit of Nasdaq, uses the knowledge, experience, and expertise of the professional staff of The Nasdaq Stock Market to offer a variety of consulting services to assist emerging and established securities markets around the world with

1996 Year In Review

both technology applications and regulation.

NIMI, working in partnership with the U.S. Agency for International Development (USAID) and the Romanian government, completed construction of the Romanian Stock Market (Rasdaq) in 1996, a project that was begun the previous year. Rasdaq licensed for use Nasdaq's proprietary trading technology known as PORTALSM, customized by NIMI to meet the needs of the Romanian marketplace. In doing so, Rasdaq brings together a wide array of today's most sophisticated communications technologies.

NIMI also developed the regulatory blueprint and infrastructure for the design and operation of the Romanian Association of Securities Dealers (ANSVM), the self-regulatory organization that oversees Rasdaq and governs the securities market for company shares offered through Romania's Mass Privatization Program. NIMI worked closely with ANSVM and the Romanian National Commission of Securities (CNVM) to fashion a full spectrum of trading rules, from membership qualifications to requirements for market making, using the self-regulatory model.

NIMI also made significant progress in 1996 on a major project for Harmonization of Capital Markets in the Caribbean. NIMI first assessed the current market models in Jamaica, Barbados, Trinidad & Tobago, and the Dominican Republic. From this assessment, together with plans for a new exchange to be established in The Bahamas, NIMI's team produced a framework design for automated trading and depository facilities for the markets, and a request for proposal for computers and software to support this regional initiative. In 1997, this project will produce additional legal and organizational enhancements as well as rollout and implementation of the automated trading and central securities depository systems.

In addition, NIMI in 1996 became the prime contractor for the second time in the Capital Market Development project for the Pakistani financial markets. Working with the Asian Development Bank (ADB), the largest donor bank in Asia, and the Aries Group, Ltd., an international consulting firm, NIMI is preparing the outline structure for the remodeling of the Pakistani capital markets, including the stock exchanges, mutual fund industry, and the leasing industry. NIMI is overseeing the work performed by the team of consultants in addition to guiding the Corporate Law Authority in Pakistan on the overall process of privatization.

Nasdaq Celebrates 25th Anniversary With Essay Contest for Students

The Nasdaq Stock Market chose to celebrate its 25th anniversary in 1996 by encouraging the younger generation to learn about stock markets and the role they play in America's economy. To accomplish this, Nasdaq organized an essay contest for students in five age categories from 5 to 18 years of age. The topic of the essay was "What Stock Markets Mean to America." In all, more than 2,200 children

from 49 states, Washington, D.C., Puerto Rico, British Columbia, and Japan submitted essays. The essays were judged by more than 60 staff volunteers from the NASD and its subsidiaries.

Six grand prize winners (there was a tie in one category) and a special grand prize winner were awarded \$1,000 to invest and a three-day trip to Washington with two family members. At the presentation ceremony the winners read their essays and were presented their awards by the Presidents of the NASD, NASD Regulation, and Nasdaq as well as former NASD President Gordon Macklin. In addition to the grand prize winners, 18 other winners from around the country received \$1,000 for their efforts.

The grand prize winners and their age categories were as follows:

Name	Hometown	Age Group
Matthew Hostetter	Frederick, Maryland	5-6
Emily Kuster	Johnston, Iowa	7-9
Herman Galatas, Jr.	Gretna, Louisiana	10-12
Stephanie Kelly	Bordentown, New Jersey	13-15
Jonah Lehrer	Los Angeles, California	13-15
Kelly McClintock	Brooklyn, New York	16-18
Jeremy Herrmann	Pepper Pike, Ohio	*

* Special Grand Prize Winner

The Nasdaq Stock Market Educational Foundation, Inc.

The Nasdaq Stock Market Educational Foundation, Inc., provides financial support to programs and projects that foster economic literacy, promote understanding of the capital formation process, and provide an education on how securities markets operate and function. The Foundation was established in 1993 as an independent nonprofit entity wholly funded by The Nasdaq Stock Market, Inc.

In 1996, the third year of operation, the Foundation awarded a number of general support grants to various financial research centers of major universities and the National Council on Economic Education. In addition, the Foundation issued grants to fund an assortment of specific projects.

- *Columbia University Graduate School of Journalism*—a grant for the endowment of the Knight-Bagehot Fellowship for mid-career professional development of journalists reporting on business and economics.
- *Council on Economic Education in Maryland*—funds to purchase computer equipment to promote the computerized version of the Stock Market Game.
- *George Washington University's Financial Markets Research Center of the School of Business and Public Management*—a grant to develop an MBA course module covering financing alternatives for emerging companies and the strategic considerations of an IPO.
- *Georgetown University School of Business*—a grant to offer a course on the process of taking a company public and an executive program on the functioning and regulation of capital markets.
- *Philadelphia's Julia De Burgos Bilingual Middle Magnet School*—funds to support its Program for Economic Development that teaches students about free enterprise, investment, stock markets, and generation of capital.
- *Museum of American Financial History*—a general support grant to help the Museum preserve and display artifacts and testimony related to the nation's financial heritage, organize exhibitions, produce publications, and provide research facilities.
- *Academy of Finance of the National Academy Foundation*—a grant to support the Academy's works introducing students to the securities and financial services industry through curriculum studies, paid student internships, and mentoring programs.
- *National Press Foundation*—a grant for its Washington Seminar on Finance and Economics, providing journalists, chosen through a nationwide competition, the opportunity to discuss contemporary financial issues with experts from economics, finance, government, agencies, and research institutions in Washington, D.C.
- *New York University's Leonard N. Stern School of Business*—funds to develop and offer a course on global equity markets covering trading and market structure.
- *Securities Industry Foundation for Economic Education*—funding to support the Stock Market Game, an on-line simulation exercise that teaches elementary and secondary school students the basic principles of economics, finance, capital formation, and securities markets.
- *Research Institute for Small and Emerging Business*—a grant to create a fellowship in capital formation for small business that will bring an established academic to Washington, D.C. for a semester to serve on the staff of a Congressional committee that sets policies and develops legislation on the funding of small business and to meet with appropriate agencies, trade associations, and research institutes.
- *University of Maryland, the Maryland Business School*—a grant to develop and offer a course in equity markets structure and economics, covering, among other topics, comparative market structure, operations, regulation, trading mechanisms, order taking, performance, and the roles of various market participants.

In addition to these grants, the Foundation awarded Ph.D. dissertation fellowships to New York University, Carnegie Mellon University, and the University of California at Berkeley. The Foundation also funded the second year of a full four-year Ph.D. fellowship awarded to the University of Chicago in 1995. The respective universities select the recipients of these grants from among full-time doctoral students in finance or economics whose dissertations and/or research involve aspects of the capital formation process or the operation and functioning of securities markets.

NASD Regulation, Inc. Review of Operations, 1996

Structural Changes Focused on Regulatory Mission

Governance Revised

To ensure that the public is adequately represented in NASD Regulation's affairs, a board structure was chosen that balances industry and non-industry directors. A major accomplishment of NASD RegulationSM in 1996 was assembling a board of highly competent and dedicated directors, one that is committed to the company's mission of investor protection and capable of successfully guiding it through its critically important first year.

Organization Streamlined

In 1996, NASD Regulation moved to make its regulatory and oversight functions more efficient by implementing a streamlined organizational structure. Three separate departments responsible for most of the regulation of the nation's securities firms and their registered representatives were created—Enforcement, Member Regulation, and Market Regulation. In addition, five operating offices were created to administer NASD Regulation programs and policies—Dispute Resolution, Disclosure and Investor Protection, Disciplinary Policy, Technology Services, and General Counsel.

During 1996, NASD Regulation assembled a strong senior management team to lead the company. In addition to NASD[®] veterans, this team includes former senior executives from the SEC and the Commodity Futures Trading Commission.

Regulatory Resources Increased

A multi-million dollar budget increase in 1996 made it possible for NASD Regulation to expand significantly the number of staff dedicated to regulation and enforcement. In all, a total of 137 new positions, largely dedicated to member firm examination and market surveillance, were added to the NASD Regulation workforce, which totaled 1,635 at the end of 1996. The NASD Board has made a major additional commitment to enhance its regulatory program. Over the next five years, the NASD also plans to spend more than \$100 million to enhance its systems for market surveillance and increase examination, surveillance, enforcement, and internal audit staff.



Mary L. Schapiro
President, NASD Regulation, Inc.

Solid Regulatory Results Achieved

Disciplinary Actions Increased

In 1996, NASD Regulation sent a strong message that it will not tolerate violations of NASD and MSRB rules and federal securities laws. Disciplinary actions brought by NASD Regulation reached 1,200 in 1996, an increase of 12 percent over 1995, and collected disciplinary fines increased by almost two-thirds. Among the most significant actions concluded were the expulsion from NASD membership of Hibbard Brown & Co., Inc., in February and Stratton Oakmont, Inc., in December. Twelve other firms were either expelled or suspended from membership, while 598 individuals were either barred or suspended.

District Office Examination Program Broadened

During 1996, NASD Regulation District Office examiners conducted almost 2,400 routine examinations of NASD members, an increase of 54 percent over the previous year. In addition to reviewing members' financial and operational condition, NASD Regulation examinations also focused heavily on sales practices and supervision involving areas such as suitability, churning, best execution, fairness of markups and commissions, and fraudulent activity.

Close to 10,500 special cause matters were investigated and resolved by the Districts, which included customer complaints and ter-

minations for cause of persons associated with members. Further, the District Offices, in coordination with NASD Regulation's Enforcement Department, concluded a number of major sales-practice investigations.

Registered Representatives Barred for Cheating

During 1996, NASD Regulation barred from the securities industry a total of 21 registered representatives for having paid impostors to take qualification examinations on their behalf. These examinations are a critical component of the investor protection program. NASD Regulation worked closely with the Manhattan District Attorney's office in the indictments of 52 impostors and others implicated in this matter.

Joint Operation Uncovers Illegal Payments

In October 1996, the Justice Department charged 45 stock promoters, company officials, and current or former brokers with conspiracy, securities fraud, and criminal contempt following extensive investigations into illegal payments made to securities brokers to induce them to sell particular securities. In concert with the United States Attorney's Office for the Southern District of New York, the Federal Bureau of Investigation (FBI), and the SEC, NASD Regulation was an active participant in this investigation, contributing hundreds of hours of staff time as well as market information, technical expertise, and other assistance crucial to the success of this undercover sting operation.

Investigation of Penny Stock Fraud Leads to Convictions

In another joint regulatory initiative, NASD Regulation assisted the U.S. Attorney in New Jersey obtain criminal convictions of a large number of individuals for illegal activities in low-priced stocks. For the past several years, NASD Regulation has had full-time examination staff assigned to work with the FBI in Newark, New Jersey, too.

In commenting on this case, FBI Director Louis Freeh commended NASD Regulation for the "vital role" it played "during several substantial investigations involving the securities markets." Freeh called the work of NASD Regulation staff over the last several years "tireless," and added that they "contributed immensely to the convictions of more than 30 persons."

Outreach to Individual Investors Undertaken

NASD Regulation Launches World Wide Web Site

Using the latest technology to facilitate investor access, NASD Regulation established a site on the World Wide Web (www.nasdr.com) that provides investors a basic primer on how the regulatory process works, how investors can avoid problems before they occur, and steps

they can take should they run into difficulty. The site contains an overview of NASD Regulation's activities, information on investing wisely, timely messages on current regulatory developments, and descriptions of the arbitration and mediation process. It also allows investors the on-line ability to request information on the disciplinary histories of securities firms and their brokers, and to file complaints electronically.

Public Participation Solicited in NASD Rule Comment Process

In November, NASD Regulation boosted the voice of investors in its rule-making process by being the first self-regulatory organization to give investors the opportunity to comment on its rule proposals via its Web site, well in advance of their publication by the SEC in the *Federal Register*.

NASD Regulation Proposes Expansion of Disciplinary History Available Through Public Disclosure Program

In 1996, the NASD Public Disclosure Program responded to over 133,000 telephone requests from the general public for the disciplinary histories of NASD member firms and their brokers through its toll-free hotline (800-289-9999). In addition to information provided over the telephone, NASD Regulation mailed over 102,000 reports in response to these requests.

This reportable information includes a wide range of criminal and disciplinary information, arbitration decisions, and civil judgments. In 1996, NASD Regulation proposed to expand the information available to include, among other things, pending customer complaints and arbitrations, and suspension or revocation to act in a professional capacity.

Communications with Investors Improved

Regulation of Broker/Dealers' Use of Electronic Media Clarified

The use of electronic media—including Internet and other on-line commercial services' sites, chat rooms, bulletin boards, and e-mail—to disseminate securities-related information and communicate with customers saw explosive growth in 1996. Concerned about the protection of investors, NASD Regulation undertook an informational program for NASD member firms to clarify how certain current standards for hard copy and telephone communications also apply to electronic media. These standards include the application of rules governing suitability of investment recommendations, supervisory review of certain communications, and NASD Regulation review of advertising material.

Investors Internet Education Program Introduced

During 1996, NASD Regulation observed a correlation between sharp increases in the number of electronic messages relating to certain low-priced securities and dramatic increases in their price, volatility, and trading volume. Often, these messages are sent without attribution to a large, undifferentiated universe of Internet or on-line service subscribers and contain unverified or potentially misleading information.

To alert investors to potential fraud, NASD Regulation initiated an Internet Education Program, the key element of which is a brochure—*Possibilities and Pitfalls: The Internet as an Investment Tool*—distributed free to investors through the NASD and its member firms either on-line or by mail. The brochure provides guidelines for using securities information on the Internet safely. In addition, NASD Regulation has arranged with on-line services and operators of Internet sites, bulletin boards, and chat rooms containing securities information to display a warning message to users. NASD Regulation will vigorously enforce NASD rules in any situation involving the use of the Internet to commit fraud.

Additional Telemarketing Rules Created to Protect Investors

In 1995, the NASD adopted a “cold call” rule requiring NASD member firms to keep “do not call” lists of persons who do not wish to receive telephone solicitations from the securities firm or its brokers. In addition, to protect investors from deceptive or abusive telephone calls from brokers, NASD Regulation proposed new telemarketing rules in 1996 that the SEC approved. Under the new rules, securities firms and their brokers may not telephone an individual’s residence to solicit the purchase of securities or related services at any time other than between 8 a.m. and 9 p.m. local time, unless they have the prior consent of the person.

In making sales calls, member firms and brokers must immediately give their names, the name of their firm, their telephone number or address, and state that the purpose of the call is to sell securities or related products. Finally, securities firms and their brokers may not use telephone authorization for obtaining demand drafts drawn on a customer’s account. Written authorization is required.

Dispute Resolution Refined for Investors

Arbitration Task Force Makes Historic Recommendations

The NASD provides a forum for over 87 percent of the arbitration claims brought in the securities industry each year. In 1996, an NASD Arbitration Policy Task Force, chaired by former SEC Chairman David S. Ruder, presented to the NASD more than 70 recommendations, representing the most comprehensive revamping of securities industry arbitration since 1989. The recommendations related primarily to 13 areas of the dispute resolution program, including predispute arbitration agreements, the

six-year eligibility rule, punitive damages, mediation and early neutral evaluation, a revised three-tier system, discovery, management of the arbitrator pool, arbitration of employment related disputes, standards for representation of parties in securities arbitration, financing and staffing, and governance of the arbitration process.

During the past year, NASD Regulation staff and the National Arbitration and Mediation Committee reviewed and developed the Task Force recommendations in three stages: customer-industry disputes, employee-member firm disputes, and member firm-member firm disputes. In July 1996, the NASD Regulation Board approved increases in staff to support a number of the proposed initiatives, including staff dedicated to case administration. The Board also approved an initiative to accelerate appointment of arbitrators to resolve discovery and other preliminary motions and to schedule evidentiary hearings. In September 1996, the Board endorsed the list selection method for the appointment of arbitrators and adopted a rule to expand the cases that could be decided by a single arbitrator. In November, the Board approved a rule allowing punitive damage awards in public customer arbitrations; the rule caps available damages at the lesser of \$750,000 or two times compensatory damages.

In 1997, the NASD Regulation Board will act on Task Force recommendations to improve the discovery process, clarify the contents of predispute agreements signed by public customers, and modify the eligibility rule so that investors will have a single forum (court or arbitration) in which to assert all their claims, no matter when the transaction took place. All of these rules will have to be approved by the SEC, after a period of notice and comment.

More Qualified Arbitrators Added and Training Upgraded

In 1996, NASD Regulation substantially increased its roster of qualified arbitrators to accommodate the increase in cases and to give investors a wider choice among arbitrators. Also, the NASD Regulation Board approved increases in staff dedicated to the recruitment and training of arbitrators.

In addition, following a recommendation by the NASD Arbitration Task Force, NASD Regulation completely revamped its required arbitrator training programs and materials. The new two-part training program increases arbitrator education by combining the benefits of self-paced home study and participatory classroom-style instruction. In 1997, NASD Regulation will continue the process of updating existing materials and will develop new training tools and methodologies.

Mediation Proves to Be A Successful Alternative

NASD Regulation’s mediation program completed its first full year of operation in 1996. For the year, more than 82 percent of the claims submitted to mediation settled. The claims brought to mediation ranged from \$10,000 to \$5 million. In all, 428 mediation cases were closed, with 351

1996 NASD Regulation Statistical Highlights

Compliance

2,359	Main office routine examinations conducted
3,892	Terminations for cause received
4,103	Terminations for cause resolved
1,121	Other cause examinations completed
5,262	Customer complaints received
5,221	Customer complaints resolved

Disciplinary Actions

1,200	Formal actions filed
1,045	Formal actions resolved
7	Firms expelled from membership
394	Individuals barred from the industry
7	Firms suspended from membership
204	Individuals suspended

Automated Market Surveillance

6,247	Price and volume alerts
230	Formal investigations conducted
136	Cases referred to the SEC

Advertising

53,241	Items reviewed from filings, spot checks, and investigations
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Corporate Financing

2,718	Underwriting arrangements reviewed
\$337.8	Billion of public offerings reviewed

Arbitration

5,631	Cases filed
6,331	Cases closed
4,119	Disputes resolved between parties without arbitration
397	Industry cases arbitrated
1,815	Customer cases arbitrated
977	Cases decided in favor of customers

Mediation

651	Cases brought
428	Cases closed
351	Cases settled

Qualifications

267,754	Registered representatives and principal tests administered
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Continuing Education

103,000	Training sessions delivered
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Information reflects data as of December 31, 1996

being settled. In view of the success and popularity of the mediation program, in 1996 the NASD approved increases in staff dedicated to mediation.

Regulatory and Compliance Capabilities Strengthened

Sales-Practice Rules Applied to Government Securities Transactions

To safeguard the interests of investors, the SEC approved NASD rule changes providing the NASD with fuller authority and expanding the scope of its sales-practice requirements to broker/dealers engaged in a government securities business. These rules address matters of fair dealing, suitability of recommendations to customers, accurate and firm quotations, best execution of customer orders, and reasonable charges for services performed. Previously, NASD regulation of govern-

ment securities was limited to financial and operational activities, advertising requirements, and certain recordkeeping and supervision rules.

Bank Broker/Dealer Rules Emphasize Product Differentiation

The NASD filed a new rule with the SEC in 1996 designed to eliminate the confusion that may arise when both insured deposit instruments and securities products, such as mutual funds, are offered to retail customers from a single location on the premises of a bank or other financial institution.

A major feature of the rule is the requirement that an NASD member firm located at a financial institution (e.g., bank, savings and loan, or credit union) conduct its securities business in a location distinct from the area where deposits are taken, whenever possible,

and in all situations clearly distinguish the member's broker/dealer services from the financial institution's deposit-taking activities. According to another requirement, the NASD member must provide customers orally and in writing an explanation of the differences in insurance coverage and risks between securities and non-securities products.

Restrictions and Disclosure of Broker/Dealer Incentives Refined and Expanded

In 1996, the NASD built on the steps it took the previous year to restrict the cash and non-cash compensation received by broker/dealers and their associated persons who sell investment company and variable contract securities. These actions are in response to the increasing use of non-cash compensation as an incentive to encourage the sale of these products.

Amendments proposed in 1996 to the original 1995 rule currently pending before the SEC would require, among other things, that any cash or non-cash compensation that is or may be received by the member or its associated persons when selling investment company securities be disclosed in a current prospectus of the investment company.

Another set of amendments proposed in 1996 would, among other items, prohibit an NASD member firm from favoring or disfavoring the sale of a variable life insurance or variable annuity contract on the basis of brokerage commissions that it would receive, and require this compensation to be disclosed in the prospectus.

Payment for Quotation or Listing Prohibited

To ensure market integrity, NASD Regulation proposed a rule that would prohibit any payment by an issuer or the issuer's affiliates and promoters, directly or indirectly, to an NASD member firm for publishing a quotation, acting as a Market Maker, or submitting an application to be a Market Maker. This rule is designed, among other things, to ensure that NASD members act in an independent capacity when publishing a quotation or making a market in an issuer's securities.

New Regulatory Technology Applications Underway

In 1996, NASD Regulation moved forward to construct an automated Order Audit Trail SystemSM to enable it to determine more efficiently whether a customer's order is executed promptly and given priority and best execution under SEC and NASD rules and regulations. Overall, this comprehensive, computerized recordkeeping system will greatly reduce the time currently required for data collection, on-site inspections, and examination of hard copy trading records.

Using cutting-edge technology to stay ahead of the regulatory chal-

lenges that advanced technology poses, NASD Regulation also started work on developing an Automated Internet Surveillance capability using a customized search engine. This system will notify market surveillance analysts of promotional activity on the Internet in advance of market movements and enable NASD Regulation to integrate Internet surveillance more fully into its overall surveillance program and systems.

In addition, NASD Regulation began development in 1996 of several automated trade-abuse detection systems—Late-Trade Reporting Detection, Pricing/Size Convention, and Market Participant Coordination.

NASD Regulation Receives Technology Awards for Regulatory Systems

Indicative of the quality and sophistication of its systems, NASD Regulation received several awards in 1996 for the application of technology to market surveillance and examiner training. For the Research and Data Analysis RepositorySM (RADARSM) system, NASD Regulation received an award from the annual Computerworld Smithsonian Awards Program, and the system's descriptive materials were made part of the Smithsonian Institution's Permanent Research Collection. Deployed in 1995, RADAR provides market analysts immediate access to market data and other related information, dramatically increasing the speed and flexibility with which large quantities of data are processed and analyzed.

The CornerStone[®] Examiner Training Program and Performance Support System was recognized by the International Society for Performance Improvement (ISPI) as the Outstanding Human Performance Support System for 1996. CornerStone is a combination of print- and computer-based training, along with classroom and on-the-job education used in teaching examiners.

The Automated Examination Modules (AEM), an automated tool augmenting CornerStone, was awarded first prize for Outstanding Custom Application by Microsoft Corporation. AEM allows NASD Regulation's national compliance and examination staff to conduct on-site examinations of member firms using a laptop computer applying software that contains all NASD Regulation examination policies and procedures along with on-line product information.

Professionalism of the Industry Improved

Continuing Education Services Enhanced

To help NASD member firms to comply with the Firm Element of the mandated Continuing Education Program for industry professionals, NASD Regulation offered members a new software release to assist them in completing a training needs analysis and developing and implementing a written training plan.

1996 Year In Review

Also in 1996, NASD Regulation instituted a notification program through the Central Registration DepositorySM to provide NASD member firms with advisory messages when significant disciplinary actions involving their registered representatives require them to be entered into the Regulatory Element of the Continuing Education Program.

Number of Testing/Training Sites Increased

To enhance the effectiveness of the Continuing Education Program and the operation of the testing process, NASD Regulation entered into a strategic relationship with Sylvan Learning Systems, Inc., to increase by more than fivefold the number of centers available to test, train, and certify the nation's more than 530,000 registered brokers. The number of secure, computerized facilities will increase from 56 across the country to over 250 in all 50 states over the next two years. NASD Regulation will continue to guard the integrity and security of the testing process, and will register candidates and prepare computerized tests for delivery. Sylvan will manage and operate the training/testing centers.

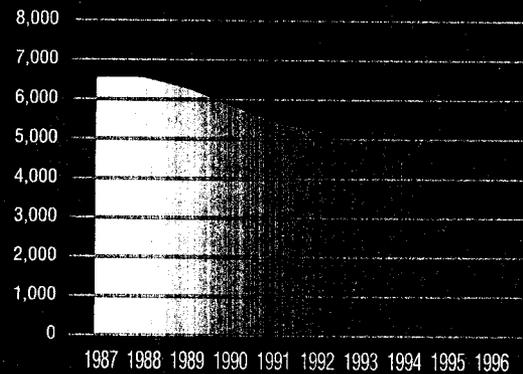
New Examinations to Be Introduced

The NASD Regulation and NASD Boards approved the creation of two new examinations for government securities and corporate securities traders. Adding these examinations will help educate the thousands of brokers who specialize in selling government securities and traders who specialize in trading corporate equities at a time when the market for both, and their complexity, is growing.

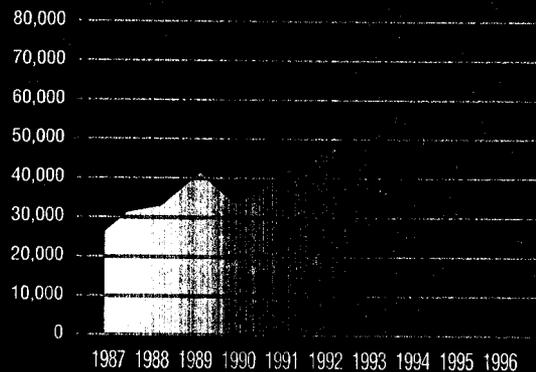
The government securities examination is made possible by, and is an appropriate implementation of, the expansion by Congress of NASD regulatory authority. The corporate securities trading examination will ensure that traders have a more consistent understanding of securities industry rules, especially in light of the rapid regulatory and structural changes in the marketplace.

Ten-Year Review / INDUSTRY

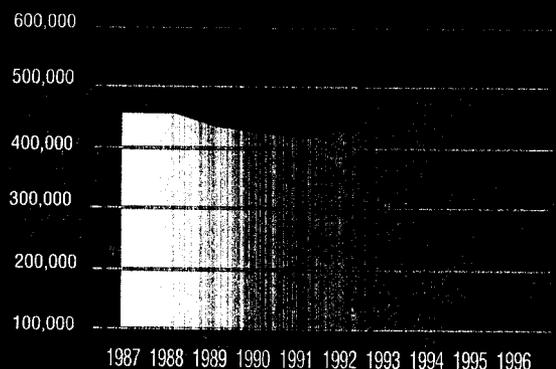
Member Firms



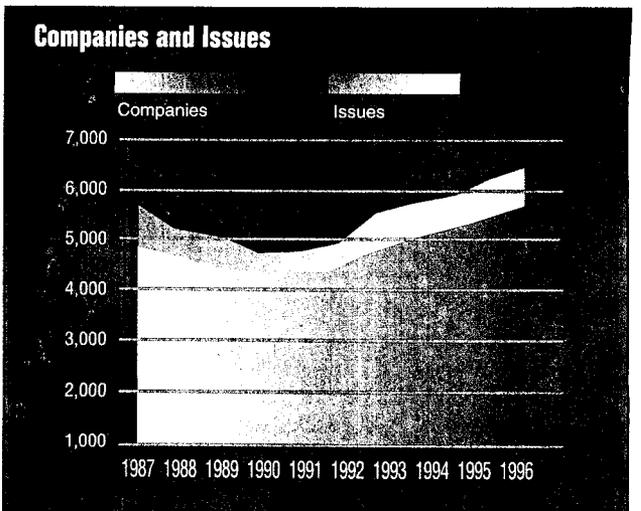
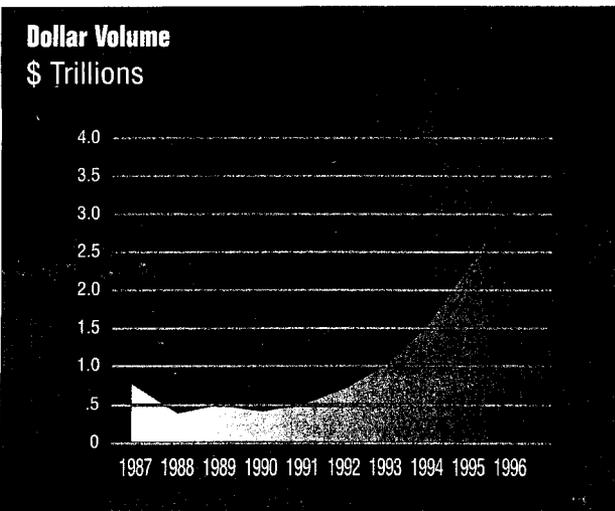
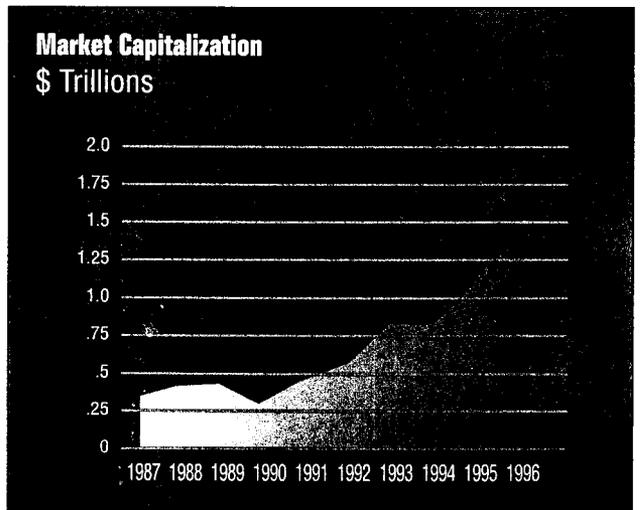
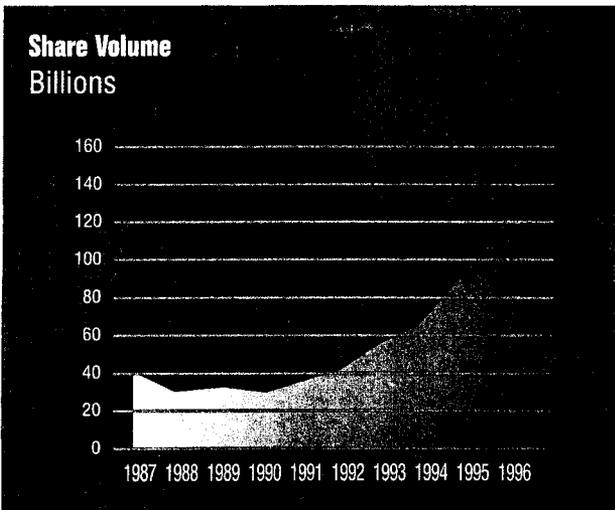
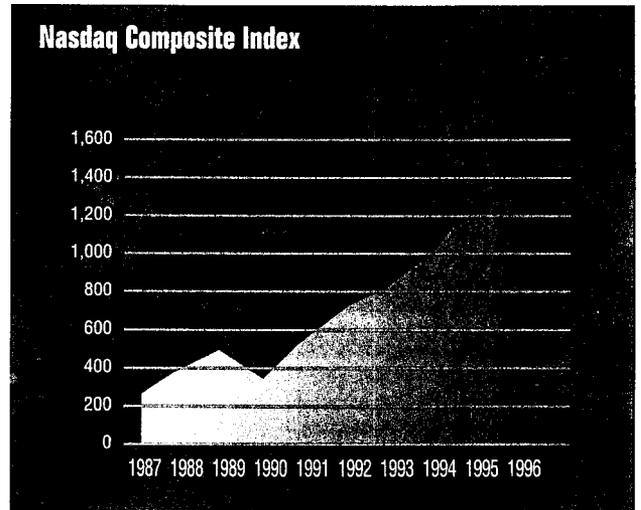
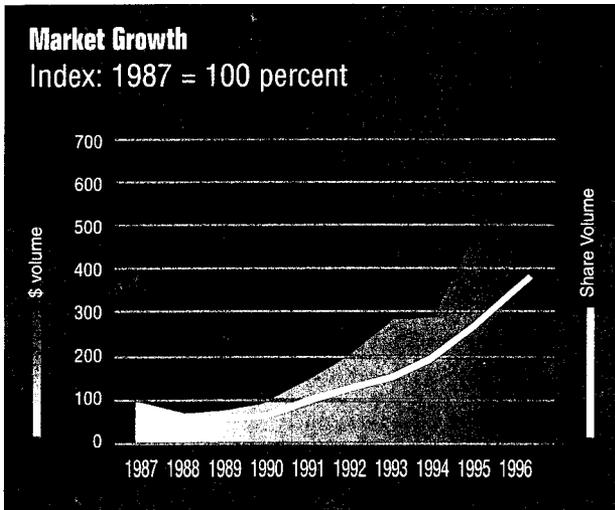
Branch Offices



Registered Representatives

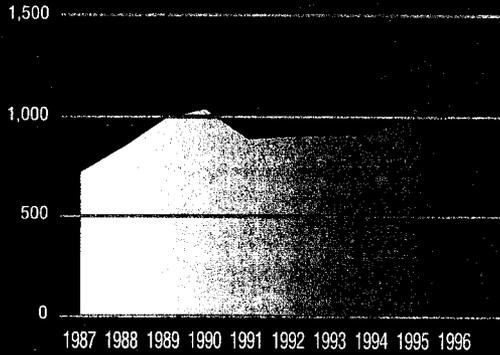


Ten-Year Review / NASDAQ MARKET PERFORMANCE

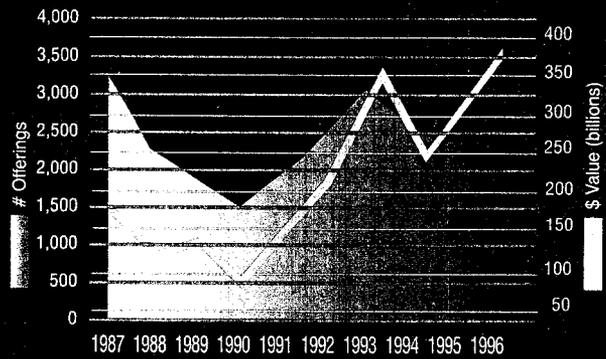


Ten-Year Review / INVESTOR PROTECTION

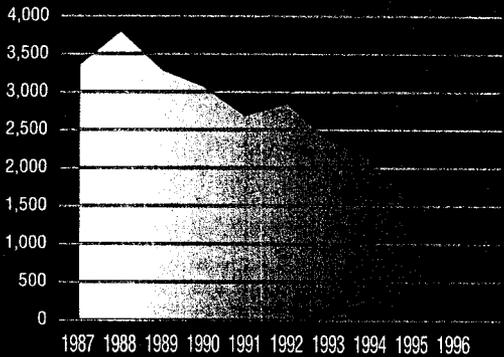
Formal Disciplinary Actions Filed



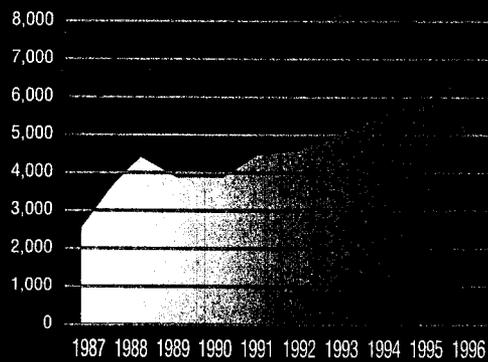
Corporate Financing Underwriting Arrangements Reviewed



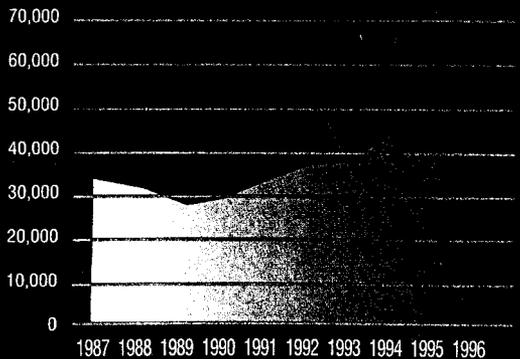
Main Office Routine Examinations Conducted



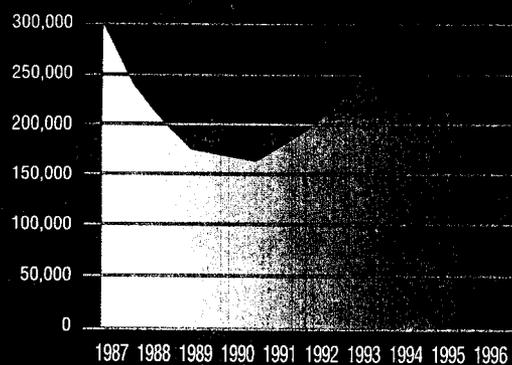
Arbitration Cases Filed



Advertising Items Reviewed



Qualification Examinations



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