NASD

2002 ANNUAL FINANCIAL REPORT


WE ARE NASD

MESSAGE FROM THE CHAIRMAN

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

NASD'S STRUCTURE AND FINANCES

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

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

REGULATION TO RESTORE INVESTOR CONFIDENCE

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

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

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

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

INVESTOR EDUCATION

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

MARKET OPERATIONS AND INFORMATION SERVICES

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

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

EXPANDING NASD'S REACH

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

HOLDING DOWN MEMBER COSTS AND BURDENS

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

EXTENDING OUR LEADERSHIP IN DISPUTE RESOLUTION

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

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

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

CONCLUSION

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

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

Robert R. Glauber

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

NASD 2002 THE YEAR IN NUMBERS

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

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

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

INVESTOR COMPLAINTS

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

NASD PUBLIC DISCLOSURE PROGRAM

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

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

REGULATORY ACTIONS

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

TESTING AND CONTINUING EDUCATION

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

CORPORATE BOND TRANSPARENCY

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

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

MARKET SURVEILLANCE

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

CORPORATE FINANCING

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

DISPUTE RESOLUTION

ARBITRATION

Cases filed	7,704
Cases closed	5,957

How arbitration cases were closed:

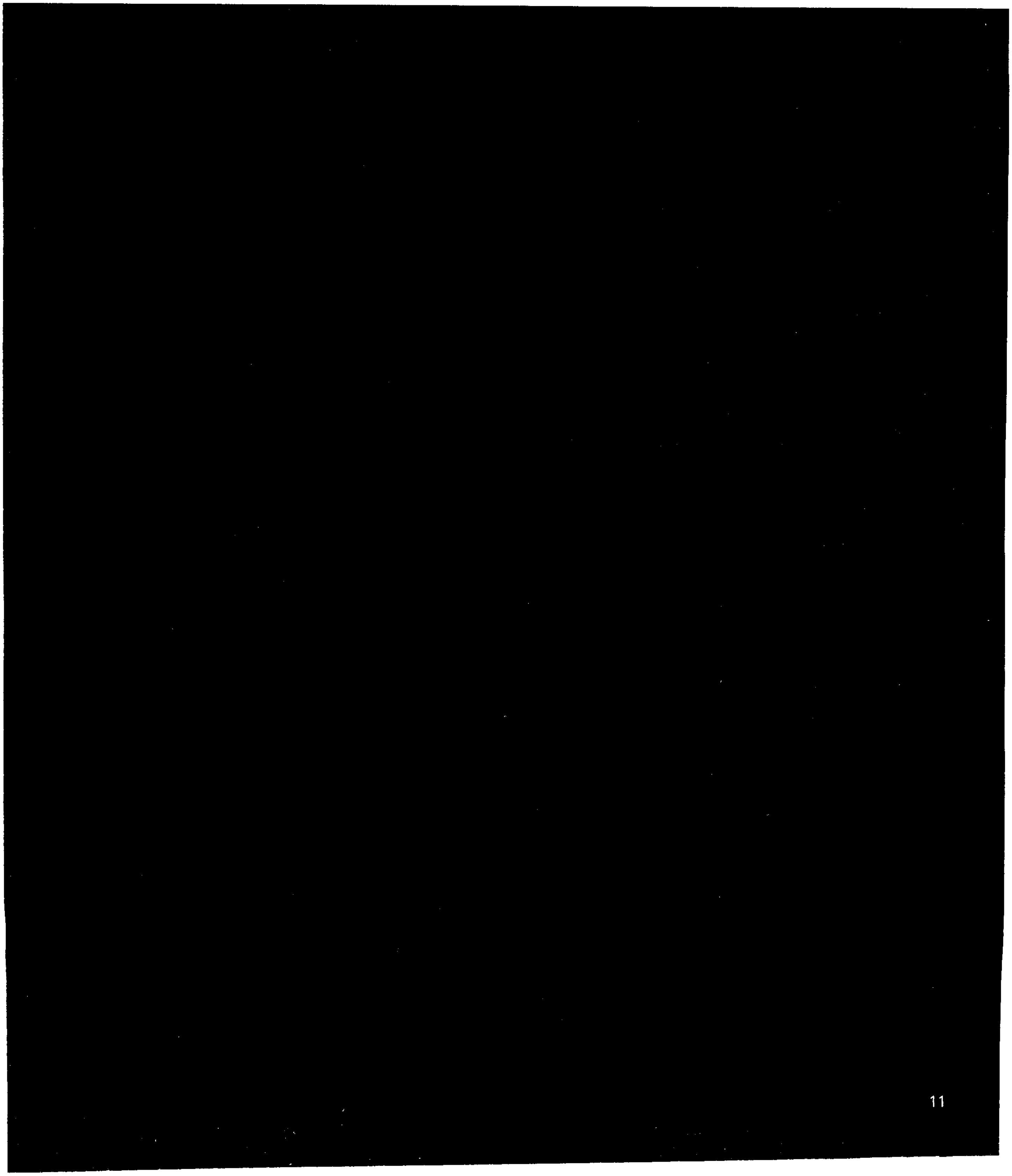
Closed after hearing	1,463
Closed after review of documents	443
Settled by the parties	2,204
Settled by mediation	752
Withdrawn	547
*All other	489

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

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

MEDIATION

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



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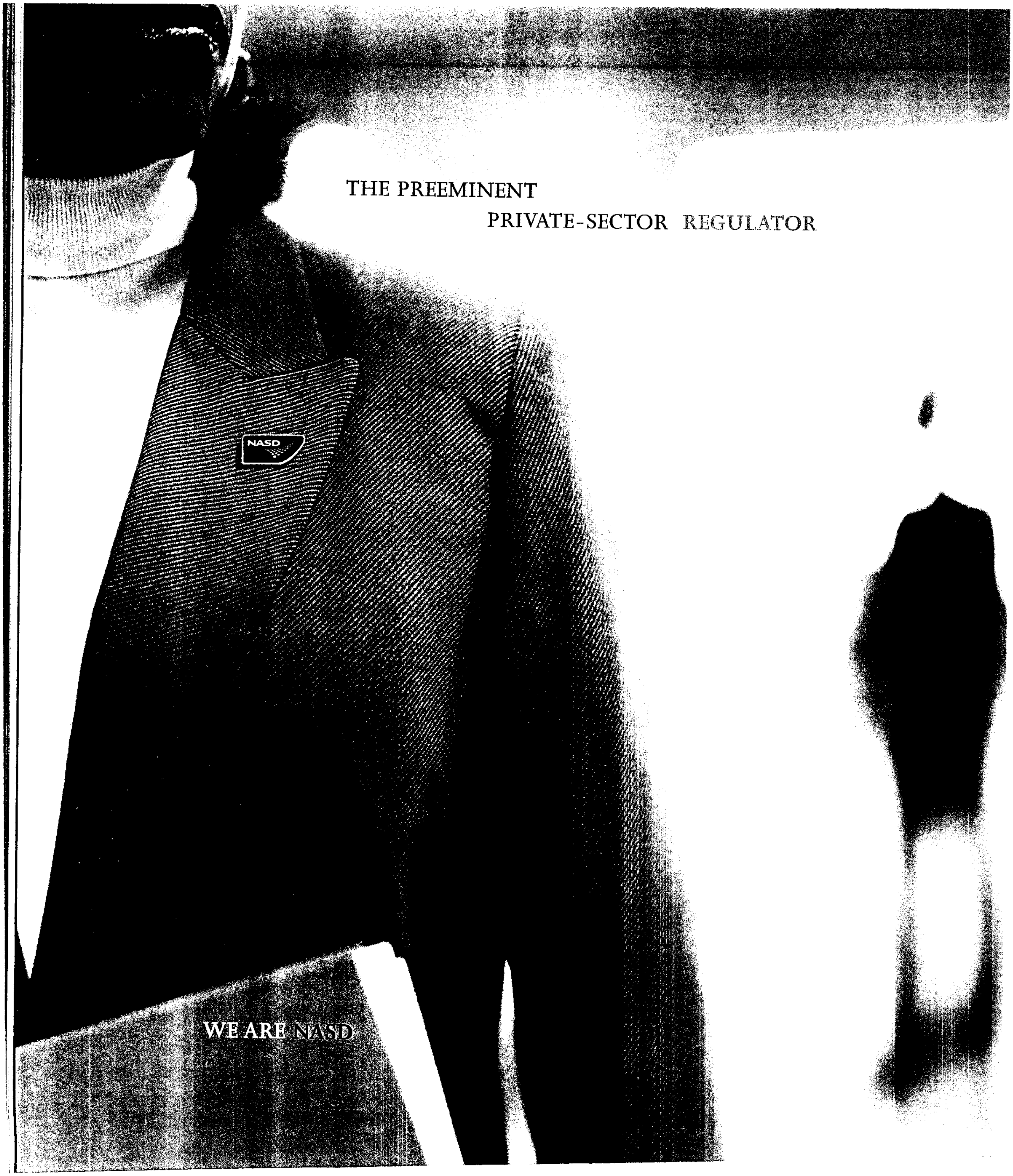
THE PREEMINENT
PRIVATE-SECTOR REGULATOR
NASD
WE ARE NASD

OVERVIEW

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

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

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

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

INVESTOR PROTECTION AND MARKET INTEGRITY

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

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

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

NEW SYSTEMS, PRODUCTS AND TECHNOLOGIES

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

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

PRICING

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

COST SAVINGS & MEMBER REBATES

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

NASDAQ RESTRUCTURING

In 2002, NASD and NASDAQ moved a final step closer to completing the separation of the two entities that was first decided upon in 2000. In March 2002, NASD sold an additional 33.8 million shares of NASDAQ common stock to NASDAQ, reducing its ownership of NASDAQ to roughly 55 percent prior to the exercise of warrants. Assuming the full exercise of all warrants purchased in Phase I and II of the NASDAQ Restructuring, this transaction effectively reduced NASD's ownership of NASDAQ common shares to zero on a fully diluted basis. In exchange for the shares sold, NASDAQ paid NASD $305.2 million in cash and issued 1,338,402 of Series A Preferred Stock, as well as one share of Series B Preferred Stock.

With its 55 percent ownership and one share of Series B Preferred Stock, NASD continues to exert voting control over NASDAQ and therefore continues to consolidate NASDAQ's operations under accounting principles generally accepted in the United States. NASDAQ applied for registration as an exchange with the SEC in March 2001. Once exchange registration is approved, warrant holders will have the right to direct the voting of the shares of NASDAQ common stock underlying the unexercised and unexpired warrants and NASD will no longer exert voting control. Upon exchange registration, NASD will cease to consolidate NASDAQ's operations with NASD's results. The exact timing of exchange registration is currently unknown.

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

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

EFFECT OF NASDAQ RESTRUCTURING ACTIVITIES (DOLLARS IN MILLIONS)

	NASD Ownership %	Fully Diluted %	NASDAQ Shares Owned by NASD	Increase in Consolidated Equity	(Increase) Decrease in Minority Interests	Increase in Liabilities	Consolidated Cash Proceeds
Year Ended 12/31/99	**100.0%**	**100.0%**	**49,999**	–	–	–	–
Stock Split	100.0%	100.0%	100,000,000	–	–	–	–
Phase I – Shares	(19.4)%	(19.4)%	(323,796)	$ (138.6)	$ (118.2)	$ –	$ 256.8
Phase I – Warrants	–	(20.7)%	–	–	–	(68.7)	68.7
Ending Balance/Cumulative Impact–Year Ended 12/31/00	**80.6%**	**59.9%**	**99,676,204**	**(138.6)**	**(118.2)**	**(68.7)**	**325.5**
Phase II – Shares	(6.4)%	(6.4)%	(4,219,795)	(59.2)	(58.0)	–	117.2
Phase II – Warrants	–	(12.9)%	–	–	–	(59.9)	59.9
Hellman & Friedman	(4.3)%	(13.0)%	(18,461,538)	(40.5)	40.5	(240.0)	240.0
Other NASDAQ	(0.9)%	(2.3)%	–	(9.2)	(4.9)	–	14.1
Ending Balance/Cumulative Year Ended 12/31/01	**69.0%**	**25.3%**	**76,994,871**	**(247.5)**	**(140.6)**	**(368.6)**	**756.7**
NASDAQ Share Buyback – March 2002***	(13.5)%	(25.3)%	(33,768,895)	(122.9)	122.9	–	–
Other NASDAQ	(0.3)%	–	(20,830)	(1.0)	(1.2)	–	2.2
Ending Balance/Cumulative Year Ended 12/31/02	**55.2%**	**–**	**43,205,146**	**$ (371.4)**	**$ (18.9)**	**(368.6)**	**$ (758.9)**
Cash Proceeds – NASD*							$ 730.8
Cash Proceeds – NASDAQ**							28.1
Total Cash Proceeds							**$ 758.9**

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

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

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

Warrants to purchase NASDAQ common shares are exercisable in four annual tranches. The first annual tranche became exercisable on June 28, 2002. As of December 31, 2002, 20,830 shares had been purchased through the exercise of warrants. The first exercise period expires on June 27, 2003.

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

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

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

AMEX SALE

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

RESULTS OF OPERATIONS

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

NASD CONSOLIDATED FINANCIAL PERFORMANCE BY SEGMENT (DOLLARS IN MILLIONS)

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

REVENUES

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

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

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

EXPENSES

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

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

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

OTHER INCOME (EXPENSE)

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

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

(LOSS) INCOME FROM DISCONTINUED OPERATIONS

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


A STANDARDS-SETTER
WE ARE NASD

NASD MANAGEMENT REPORT ON FINANCIAL REPORTING RESPONSIBILITY

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

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

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

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