AUDIT COMMITTEE REPORT

In accordance with its written charter adopted by the Board of Governors, the Audit Committee of the Board of Governors assists the Board in fulfilling its responsibility for oversight of the quality and integrity of the accounting, auditing, and financial reporting practices of NASD. Each member of the Committee is an independent director. In addition, the Audit Committee has determined that James E. Burton is an audit committee financial expert, as defined by the SEC. The charter gives the Audit Committee responsibility for monitoring the independence of the independent auditors and recommending the appointment of the independent auditors for approval by the Board of Governors, and makes clear that the independent auditors are accountable to the Audit Committee and the Board of Governors, as representatives of the members and the public. In all respects, the charter complies with standards applicable to publicly owned companies. In addition, the charter and the By-laws of NASD make the director of internal audit directly responsible to the Audit Committee. (The Charter for the NASD Audit Committee is available on the Internet at the following URL: *http://www.nasd.com/corp_info/audit_committee.asp.)*

During 2002, the Committee met eight times, with all Committee members participating in all meetings.

In discharging its oversight responsibility, the Audit Committee reviewed the assessments of audit risk and the audit plans of both the independent and internal auditors. The Audit Committee also discussed with management, the internal auditors, and the independent auditors the quality and adequacy of NASD's internal controls and the internal auditors' organization, responsibilities, budget, and staffing.

The Audit Committee obtained a written statement from the independent auditors describing all relationships with NASD. The Audit Committee discussed those relationships and satisfied itself that none of the relationships were incompatible with the auditors' independence. The Committee has reviewed and approved all audit and non-audit services, before initiation of each engagement, performed by NASD's independent auditors, Ernst & Young, and the associated fees. Such services and fees are summarized in the following table:

INDEPENDENT PUBLIC ACCOUNTANT (IPA) FEES

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

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

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

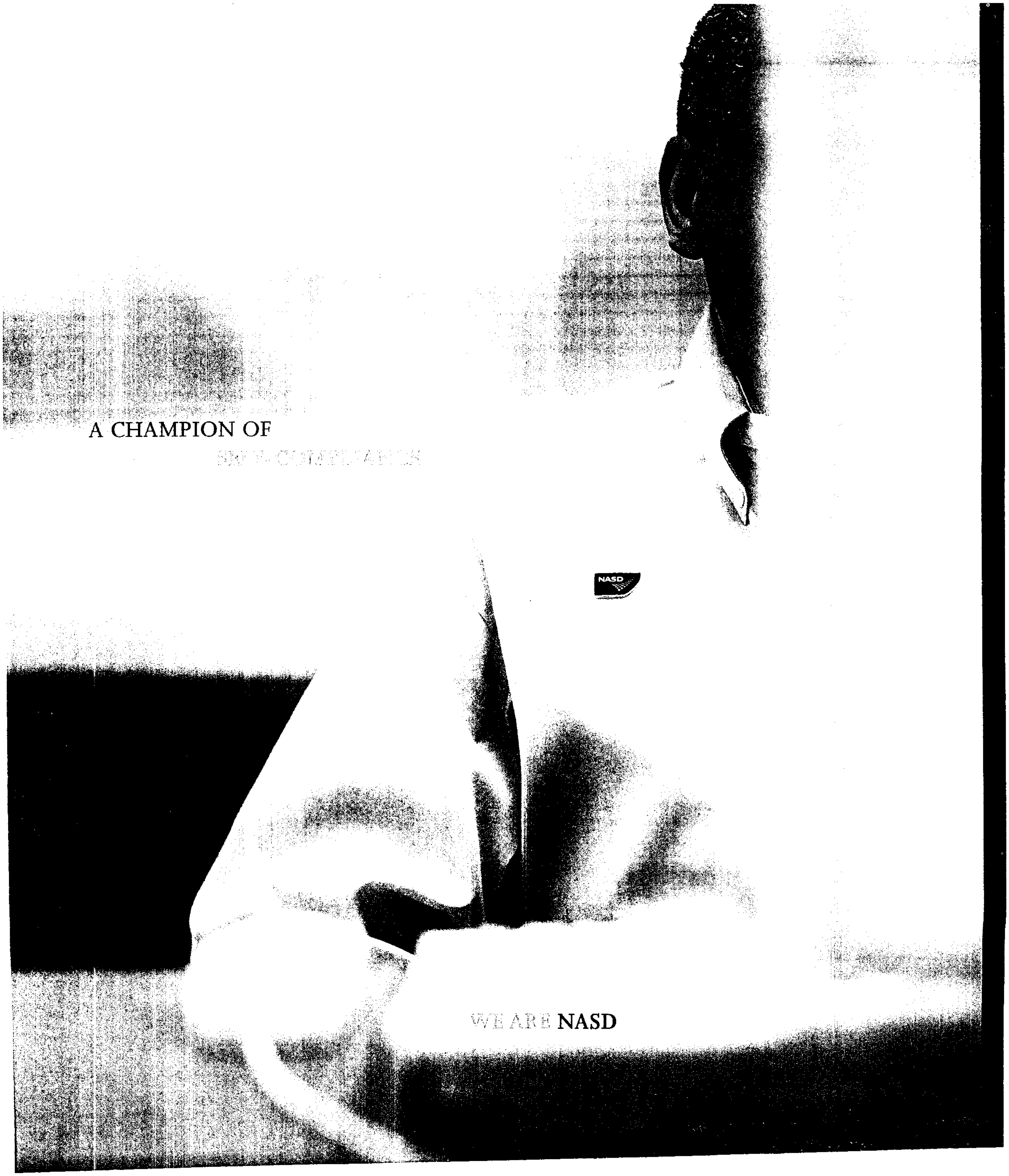
(3) Other NASDAQ services include fees associated with internal audit co-sourcing of $1.2 M and $1.4 M for 2002 and 2001, respectively.

(4) NASDAQ IPA services and fees are separately reviewed and approved by the NASDAQ Audit Committee. The NASD Audit Committee has oversight of the NASDAQ Audit Committee, but does not review actions taken with respect to the approval of IPA fees.

The Audit Committee discussed and reviewed with the independent auditors all communications required by generally accepted auditing standards and, with and without management present, discussed the results of the independent auditors' examination of the financial statements. Based on those discussions, the Audit Committee recommended to the Board of Governors that NASD's audited financial statements be included in the annual report for the year ended December 31, 2002.

Members of the Audit Committee:

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


A CHAMPION OF
NASD
WE ARE NASD

REPORT OF INDEPENDENT AUDITORS

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

We have audited the accompanying consolidated balance sheets of the National Association of Securities Dealers, Inc. d/b/a NASD ("NASD") as of December 31, 2002 and 2001, and the related consolidated statements of income, changes in members' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of NASD at December 31, 2002 and 2001, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

McLean, Virginia
June 4, 2003, except for Note 18
as to which the date is
June 26, 2003

NASD CONSOLIDATED BALANCE SHEETS *(Dollars in thousands)*

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

See accompanying notes.

NASD CONSOLIDATED BALANCE SHEETS *(Dollars in thousands)*

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

See accompanying notes.

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

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

See accompanying notes.

NASD CONSOLIDATED STATEMENTS OF CHANGES IN MEMBERS' EQUITY *(Dollars in thousands)*

	MEMBERS' EQUITY	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)	TOTAL
Balance, January 1, 2000	$ 868,952	$ 51	$ 869,003
Net income	111,999	–	111,999
Unrealized loss on available-for-sale investments, net of tax of ($1,030), net of minority interests of ($284)	–	(8,302)	(8,302)
Foreign currency translation, net of minority interests of $2,029 and net tax of ($380)	–	(2,918)	(2,918)
Minimum pension liability, net of tax of ($900), net of minority interests of ($434)	–	(961)	(961)
Comprehensive income	–	–	99,818
Increase in equity attributable to the issuance of stock by NASDAQ and its subsidiaries	38,998	–	38,998
Increase in equity attributable to Hellman & Friedman transaction	40,535	–	40,535
Decrease in equity attributable to the purchase of minority interests in NASDAQ Europe Planning Company Limited, net of minority interest of $3,203	(9,197)	–	(9,197)
Increase in equity attributable to amortization of restricted stock awards by NASDAQ, net of minority interest of $1,238	2,877	–	2,877
Balance, December 31, 2001	**1,054,164**	**(12,130)**	**1,042,034**
Net loss	**(3,480)**	**–**	**(3,480)**
Unrealized loss on available-for-sale investments, net of tax of $1,158, net of minority interests of $745	**–**	**11,843**	**11,843**
Foreign currency translation, net of minority interests of $2,034	**–**	**4,483**	**4,483**
Minimum pension liability, net of tax of $1,659, net of minority interests of $58	**–**	**(3,127)**	**(3,127)**
Comprehensive income	**–**	**–**	**9,719**
Increase in equity attributable to the NASDAQ stock repurchase from NASD	**122,947**	**–**	**122,947**
Increase in equity attributable to the issuance of stock by NASDAQ and its subsidiaries, net of minority interests of $1,203	**1,029**	**–**	**1,029**
Decrease in equity attributable to the minority partners share of NASD's net contribution to NASDAQ	**(2,260)**	**–**	**(2,260)**
Adjustment to the carrying value of NASDAQ Europe due to the sale of securities to a third party, net of minority interest of $325	**403**	**–**	**403**
Increase in equity attributable to amortization of restricted stock awards by NASDAQ, net of minority interest of $1,366	**684**	**–**	**684**
Balance, December 31, 2002	**$ 1,173,487**	**$ 1,069**	**$ 1,174,556**

See accompanying notes.

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

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

See accompanying notes.

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

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

See accompanying notes.

(Dollars in tables in thousands)

1. ORGANIZATION AND NATURE OF OPERATIONS

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

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

At a special meeting of NASD members held on April 14, 2000, more than a majority of NASD members approved a plan to broaden the ownership in NASDAQ through a two-phase private placement of (1) newly-issued shares of NASDAQ Common Stock, and (2) Common Stock and warrants to purchase shares of NASDAQ Common Stock owned by NASD (the "Restructuring"), to NASD members, NASDAQ market participants, NASDAQ issuers, institutional investors and other strategic partners. The Restructuring was intended, among other things, to strategically realign the ownership of NASDAQ, minimize potential conflicts of interest between NASDAQ and NASDR and allow NASDAQ to respond to current and future competitive challenges caused by technological advances and the increasing globalization of financial markets.

In connection with Phase I of the Restructuring, (1) NASD separated Amex from NASDAQ-Amex Market Group, Inc. ("Market Group"), a holding company which was a subsidiary of NASD; (2) Market Group was then merged with and into NASDAQ; (3) NASDAQ effected a 49,999-for-one stock dividend creating 100 million shares of Common Stock outstanding (all of which were initially owned by NASD); (4) NASDAQ authorized the issuance of an additional 30.9 million in new shares to be offered for sale by NASDAQ; and (5) NASD formed a new subsidiary, NASD Holding, to hold NASD's interest in Amex.

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

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

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

Each warrant sold by NASD during Phase I and Phase II of the Restructuring entitles the holder to purchase four shares of NASDAQ Common Stock owned and held by NASD for prices ranging from $13.00 to $16.00 per share. Each warrant is exercisable for 12 months in each of four annual tranches, with one share of NASDAQ Common Stock available for purchase in each tranche. The first annual tranche became exercisable on June 28, 2002.

On March 8, 2002, NASDAQ completed a two-stage repurchase of 33.8 million shares of its Common Stock owned by NASD, which represented all of the remaining outstanding shares of NASDAQ Common Stock owned by NASD, except for the 43.2 million shares of NASDAQ Common Stock underlying the warrants issued by NASD in Phase I and II. NASDAQ purchased the NASDAQ Common Stock for $305.2 million in aggregate cash consideration, 1.3 million shares of NASDAQ's Series A Cumulative Preferred Stock (face and

(Dollars in tables in thousands)

liquidation value of $100 per share, plus any accumulated unpaid dividends), and one share of NASDAQ's Series B Preferred Stock, (face and liquidation value of $1.00 per share). With this transaction, total combined proceeds to NASD of $439.0 million resulted in NASD realizing proceeds in excess of its basis in the underlying shares of NASDAQ of $277.5 million. In addition, as a result of the reduction in NASDAQ equity from this transaction, NASD realized a reduction in their proportionate remaining ownership of NASDAQ of $154.6 million. This transaction was another element of the continuing plan of corporate reorganization with regard to NASD's investment in NASDAQ. Accordingly, the net effect of this transaction is reflected as a $122.9 million increase in the consolidated statement of changes in members' equity in 2002.

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

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

The Series A Cumulative Preferred Stock carries a 7.6% annual dividend rate payable at the discretion of NASDAQ's Board of Directors. Dividends do not begin accruing until March 2003. Shares of Series A Preferred Stock do not have voting rights, except for the right as a class to elect two new directors to the Board of Directors anytime distributions on the Series A Preferred Stock are in arrears for four consecutive quarters and as otherwise required by Delaware law. The Series B Preferred Stock does not pay dividends. Series B Preferred Stock will be entitled to cast the number of votes that, together with all other votes that NASD is entitled to vote by virtue of ownership, proxies or voting trusts, enables NASD to cast one vote more than one-half of all votes entitled to be cast by stockholders. If NASDAQ obtains Exchange Registration, the share of Series B Preferred Stock will lose its voting rights and will be redeemed by NASDAQ. NASDAQ may redeem the shares of Series A Preferred Stock at any time after Exchange Registration and is required to use the net proceeds from an initial public offering, and upon the occurrence of certain other events, to redeem all or a portion of the Series A Preferred Stock.

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

Until NASDAQ's registration as an exchange is approved by the SEC and becomes effective ("Exchange Registration"), the shares of NASDAQ Common Stock underlying unexercised and unexpired warrant tranches, as well as the shares of NASDAQ Common Stock purchased through the exercise of warrants, will be voted by a voting trustee at the direction of NASD. Upon Exchange Registration, the warrant holders will have the right to direct the voting trustee as to the voting of the shares of NASDAQ Common Stock underlying unexercised and unexpired warrant tranches. Additionally, NASD has determined, commencing upon Exchange Registration, to vote its shares of NASDAQ common stock (other than shares underlying the outstanding warrants) in the same proportion as the other common stockholders of NASDAQ. As a result of these conditions, NASD has a controlling interest in NASDAQ until Exchange Registration is effective. As of December 31, 2002, the Exchange Registration has not become effective.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of NASD and majority owned subsidiaries. Investments, in which the company has the ability to exercise significant influence, but not control, are accounted for using the equity method. All significant intercompany accounts and transactions have been eliminated in consolidation.

USE OF ESTIMATES

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

(Dollars in tables in thousands)

CASH AND CASH EQUIVALENTS

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

INVESTMENTS

Under Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities," management determines the appropriate classification of investments at the time of purchase. Investments for which the Company does not have the intent or ability to hold to maturity are classified as "available-for-sale" and are carried at fair value, with the unrealized gains and losses, net of tax, reported as a separate component of members' equity. Investments for which the Company has the intent and ability to hold to maturity are classified as "held-to-maturity" and are carried at amortized cost. The amortized cost of debt securities classified as held-to-maturity is adjusted for amortization of premiums and accretion of discounts. Realized gains and losses on sales of securities are included in earnings using the average cost method. Amounts due to or from the custodial agent relate to securities trades executed prior to the balance sheet date but not yet settled.

The Company periodically reviews its investments to determine whether a decline in fair value below the cost basis is other-than-temporary. If the decline in the fair value is judged to be other-than-temporary, the cost basis of the investment is written down to fair value, the amount of the write-down is charged to earnings, and a new cost basis for the security is established. For the years ended December 31, 2002, and 2001, NASD recorded a charge of $33.7 million and $5.1 million, respectively, related to declines in the fair value of its investments that were judged to be other-than-temporary. These write downs are reflected in the net realized investment losses line in the consolidated statements of income.

DERIVATIVE INSTRUMENTS

On January 1, 2001, the Company adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities." SFAS No. 133, as amended and interpreted, establishes accounting and reporting standards for derivative instruments and requires that all derivatives be recorded on the balance sheet at fair value. Additionally, the accounting for changes in fair value depends on whether the derivative instrument is designated and qualifies as part of a hedging relationship and, if so, the nature of the hedging activity. Changes in the fair value of derivatives that do not qualify for hedge treatment are recognized currently in earnings.

The Company places its investment funds with outside investment managers. The Company periodically reviews its investment portfolio against the provisions of SFAS No. 133, as amended and interpreted, to identify any investment products that may have characteristics that qualify the investment as a derivative instrument. Certain available for sale investments held by the Company represented either freestanding or contained embedded derivatives. As of December 31, 2002, and 2001, the fair value of these derivative instruments was insignificant.

As discussed in Note 1, NASD issued 10.8 million warrants for the purchase of 43.2 million shares of NASDAQ Common Stock. Prior to July 2002, NASD accounted for the warrants at the amount of net proceeds received. Beginning in July 2002, NASDAQ Common Stock began trading on an over-the-counter market. Further, all transfer restrictions related to the warrants had expired. Therefore, beginning in July 2002, NASD began accounting for these warrants as derivative instruments in accordance with the provisions of SFAS No. 133, as amended and interpreted. These warrants are carried at fair value determined using a Black-Scholes model with changes in the fair value being recorded to the income statement, which resulted in a gain of $104.7 million in 2002.

RECEIVABLES, NET

The Company's receivables are primarily concentrated with NASD members, Amex member firms, market data vendors and NASDAQ issuers. Receivables are shown net of reserves for uncollectable accounts. Reserves are calculated based on the age and source of the underlying receivable and are tied to past collections experience. Total reserves netted against receivables in the consolidated balance sheets were $8.3 million and $11.1 million at December 31, 2002, and 2001, respectively.

CONCENTRATION OF RISK

Financial instruments that potentially subject the Company to concentrations of risk consist primarily of cash and cash equivalents, available-for-sale and held-to-maturity investments, and accounts receivable. The Company does not require collateral on these financial instruments.

Cash and cash equivalents are maintained principally with financial institutions located in the United States, which have high credit ratings. Risk on accounts receivable is reduced by the large number of entities comprising the Company's customer base and through ongoing evaluation of collectability of amounts owed to the Company. NASD uses multiple outside fund managers to manage its investment portfolio and a single custody agent, a domestic company headquartered in New York, to hold and report on those investments. NASDAQ conducts its investment activity through a subsidiary headquartered in Delaware.

The Company is economically dependent on three suppliers to support its operations. Those suppliers provide telecommunications services and information technology services to the Company and support back office functions for Amex trading operations. To the extent that any of these suppliers are not able to perform, it could have an adverse effect on the Company's business.

The Company's business is transacted with multiple customers, with no individual customer exceeding 10% of total revenues.

GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill represents the excess of purchase price and related costs over the value assigned to the net tangible and identifiable intangible assets of businesses acquired. As a result of the adoption of SFAS No. 142, "Goodwill and Other Intangible Assets" in the first quarter of fiscal 2002, goodwill and certain intangibles will no longer be amortized, but instead tested for impairment at least annually. Based on the impairment tests performed, there was no impairment of goodwill as of December 31, 2002. There can be no assurance that future goodwill impairment tests will not result in a charge to earnings. For the year ended December 31, 2001 goodwill and other intangible assets were amortized using the straight-line method over their estimated period of benefit, ranging from five to ten years. NASD evaluates the recoverability of intangible assets and takes into account events or circumstances that warrant revised estimates of useful lives or that indicate impairment exists. As of December 31, 2002, and 2001, goodwill and other intangibles were $22.2 million and $23.1 million, respectively, and are included in other assets in the consolidated balance sheets. Goodwill amortization expense was $1.6 million for the year ended December 31, 2001, and is included within depreciation and amortization expense in the consolidated statements of income. Other intangible asset amortization expense was $3.6 million and $3.1 million for the years ended December 31, 2002, and 2001, respectively, and is included within depreciation and amortization expense in the consolidated statements of income.

PROPERTY AND EQUIPMENT

Property and equipment are recorded at cost less accumulated depreciation. Equipment acquired under capital leases is recorded at the lower of fair value or the present value of future lease payments. Repairs and maintenance costs are expensed as incurred. Depreciation and amortization are provided on the straight-line method over estimated useful lives ranging from ten years to forty years for buildings and improvements, two years to seven years for data processing equipment and software, and five years to ten years for furniture and equipment. Leasehold improvements are amortized using the straight-line method over the lesser of the useful life of the improvement or the term of the applicable lease. Depreciation related to assets held under capital leases is included in depreciation and amortization expense in the consolidated statements of income. Depreciation and amortization expense for property and equipment totaled $149.0 million and $144.4 million for the years ended December 31, 2002, and 2001, respectively.

(Dollars in tables in thousands)

IMPAIRMENT OF LONG-LIVED ASSETS

The Company reviews its long-lived assets for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long Lived Assets." In the event that facts and circumstances indicate that long-lived assets or other assets may be impaired, an evaluation of recoverability would be performed. If an evaluation were required, the estimated future undiscounted cash flows associated with the asset would be compared to the asset's carrying amount to determine if a write-down is required. If impairment were indicated, the Company would prepare a discounted cash flow analysis to determine the amount of the impairment.

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

INVESTMENTS IN AND ADVANCES TO AFFILIATES AND SUBSIDIARIES

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

NET SEC FEES

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

DEFERRED REVENUE

Deferred revenue represents cash received and billed receivables, which are unearned until services are provided. Included in deferred revenue are unamortized Initial Listing Fees ("IL") and Listing of Additional Shares Fees ("LAS"). IL fees are recognized over six years and LAS fees are recognized over four years.

DEPOSITS AND RENEWALS

NASD member firms make deposits into the Company's Central Registration Depository ("CRD") system to pay for services including registration fees charged by states and other self-regulatory organizations. Total CRD deposits included in deposits and renewals in the consolidated balance sheets totaled $23.3 million and $24.4 million as of December 31, 2002, and 2001, respectively. CRD renewals included in deposits and renewals in the consolidated balance sheets totaled $29.3 million and $30.3 million as of December 31, 2002, and 2001, respectively.

ISSUANCE OF SUBSIDIARY STOCK

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

REVENUE RECOGNITION

Market information fees are based on the number of presentation devices in service and quotes delivered through those devices and are recognized in the month that information is provided. These revenues are recorded net of amounts due under revenue sharing arrangements with market participants. Market information services revenue is recognized in the month that information is provided. Transaction service, regulatory service fees, registration fees and qualification fees are variable based on service volumes and are recognized as transactions occur. Member assessment fees are recognized evenly over the year to which the fee relates and are recorded net of any rebates paid to members. Initial registration fees for members are

(Dollars in tables in thousands)

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

ADVERTISING COSTS

The company expenses advertising costs, which include media advertising and production costs. Advertising costs are recorded in the period in which the costs are incurred. Media advertising and production costs included as marketing and advertising in the consolidated statements of income totaled $13.3 million and $12.8 million for 2002 and 2001, respectively.

SOFTWARE COSTS

Significant purchased application software, and operational software that is an integral part of computer hardware, are capitalized and amortized on the straight-line method over their estimated useful lives, generally two to seven years. All other purchased software is charged to expense as incurred. In accordance with Statement of Position ("SOP") No. 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," the Company capitalizes internal computer software development costs incurred during the application development stage. Computer software costs incurred prior to or subsequent to the application development stage are charged to expense as incurred.

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

STOCK COMPENSATION

NASD's consolidated subsidiary, NASDAQ, maintains a stock compensation plan for its employees. NASDAQ accounts for stock option grants in accordance with Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees." NASDAQ grants stock options with an exercise price equal to the fair market value of the stock at the date of the grant, and accordingly, recognizes no compensation expense related to such grants.

Pro forma information regarding net income and earnings per share is required under SFAS No. 123, "Accounting for Stock-Based Compensation" and has been determined as if NASDAQ had accounted for all stock option grants based on the fair value method. The fair value of each stock option grant was estimated at the date of grant using the Black-Scholes valuation model assuming a weighted-average expected life of five years, weighted-average expected volatility of 30% and a weighted-average risk free interest rate of 4.31% and 4.68% for 2002 and 2001, respectively. The weighted-average fair value of options granted in 2002 and 2001 was $4.69 and $4.55, respectively.

Pro forma net income includes the amortization of the fair value of stock options over the vesting period and the difference between the fair value and the purchase price of common shares purchased by employees under the employee stock purchase plan. The pro forma net (loss) income for the years ended December 31, 2002, and December 31, 2001, was ($6.8) million and $100.8 million, respectively.

INCOME TAXES

NASD, NASDR, and NASD DR are tax-exempt organizations under the Internal Revenue Code ("IRC") Section 501(c)(6). All other consolidated subsidiaries of NASD are taxable entities. Deferred tax assets and liabilities are determined based on differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities (i.e., temporary differences) and are measured at the enacted rates that will be in effect when these differences are realized. If necessary, a valuation allowance is established to reduce deferred tax assets to the amount that is more likely than not to be realized.

(Dollars in tables in thousands)

REDUCTION IN FORCE

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

FOREIGN CURRENCY TRANSLATION

Assets and liabilities of non-U.S. subsidiaries that operate in a local currency environment are translated to U.S. Dollars at exchange rates in effect at the balance sheet date. Translation adjustments resulting from this process are charged or credited to other comprehensive income. Revenue and expenses are translated at average exchange rates during the year. Gains and losses on foreign currency transactions are included in other expenses. Foreign currency translation also includes the translation of gains and losses for non-U.S. equity method investments.

MINORITY INTERESTS

Minority interests in the consolidated balance sheets represent the minority owners' share of equity of consolidated subsidiaries, principally NASDAQ, as of the balance sheet date. Minority interests in the consolidated statements of income represent the minority owners' share of the income or loss of consolidated subsidiaries.

RECENT ACCOUNTING PRONOUNCEMENTS

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

In November 2002, the FASB issued FASB Interpretation ("FIN") No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN No. 45 provides accounting and disclosure requirements for certain guarantees. The interpretation requires certain guarantees to be recorded at fair value versus the current practice of recording a liability only when a loss is probable and reasonably estimable. The accounting provisions of FIN No. 45 are effective for certain guarantees issued or modified beginning January 1, 2003. The Company does not expect the adoption of FIN No. 45 to have a material impact on the financial statements.

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

RECLASSIFICATIONS

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

(Dollars in tables in thousands)

3. DEFERRED REVENUE

The Company accounts for issuer service revenues in accordance with Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition in Financial Statements." The Company recognizes revenue related to IL fees and LAS fees on a straight-line basis over estimated service periods. Estimated service periods for IL fees are six years, while LAS fees are recognized over a four-year service period.

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

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

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

Following is a summary of activity in the Company's current and non-current deferred revenue for the years ended December 31, 2002, and 2001 relating to IL and LAS fees. The additions reflect the fees charged during the year while the amortization reflects the fees recognized during the year based on the accounting methodology described above.

	IL FEES	LAS FEES	TOTAL FEES
Balance as of January 1, 2002	**$ 104,629**	**$ 82,424**	**$ 187,053**
Additions	**22,840**	**27,948**	**50,788**
Amortization	**(33,612)**	**(37,531)**	**(71,143)**
Balance as of December 31, 2002	**$ 93,857**	**$ $72,841**	**$ 166,698**

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

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

(Dollars in tables in thousands)

4. INVESTMENTS

Investments principally consist of U.S. Treasury securities, obligations of U.S. Government agencies, U.S. corporate debt securities, equity securities and other financial instruments. Following is a summary of investments classified as available-for-sale, which are carried at fair value as of December 31, 2002:

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

Unrealized gains (losses) from available-for-sale securities recorded in members' equity also include the Company's share of available-for-sale securities unrealized gains (losses) of equity investees.

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

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

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

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

(Dollars in tables in thousands)

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

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

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

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

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

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

5. GOODWILL AND OTHER INTANGIBLE ASSETS

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

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

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

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

6. INVESTMENT IN AND ADVANCES TO AFFILIATES AND SUBSIDIARIES

NQLX

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

(Dollars in tables in thousands)

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

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

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

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

NASDAQ JAPAN

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

During the second quarter of 2002, NASDAQ recognized an other-than-temporary impairment of its investment in NASDAQ Japan. NASDAQ recognized this impairment as a result of the depressed level of market activity in Japan, combined with the suspension of NASDAQ Japan's hybrid trading system due to the inability to gain exchange approval of market rules and industry participation. These conditions led management to conclude that NASDAQ Japan would not be profitable in the foreseeable future. Accordingly, NASDAQ Japan did not have the capacity to raise capital to fund its operations beyond 2002. Thus, NASDAQ Japan's financial liabilities to NASDAQ were not expected to be repaid and were recognized as a loss.

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

The net impact of the other-than-temporary impairment on the Company's pre-tax income the year ended December 31, 2002, was $15.2 million. This represented a complete write-down of the investment, outstanding and unfunded loans (an additional $6.0 million was loaned and $7.0 million was committed during second quarter of 2002), foreign exchange translation losses and other receivables, partially offset by a re-valuation of certain variable NASDAQ Japan stock based awards of $7.9 million.

(Dollars in tables in thousands)

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

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

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

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

NASDAQ TOOLS

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

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

NASDAQ DEUTSCHLAND

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

NASDAQ MEMBER REVENUE SHARING

Effective June 1, 2002, NASDAQ terminated its market data revenue sharing program for securities listed on The NASDAQ Stock Market, as a result of the SEC's decision to abrogate certain market participant tape sharing pilot programs. The SEC's action was in response to concerns about the effect of market data rebates on the accuracy of market data and the regulatory functions of self-regulatory organizations. The SEC's action

(Dollars in tables in thousands)

allows NASDAQ and competing exchanges to retain tape revenue. NASDAQ continues to share market data revenue with the exchanges that participate in the Unlisted Trading Privileges ("UTP") Plan based on their respective share of volume and trades of securities listed on The NASDAQ Stock Market. In addition, NASDAQ InterMarket continues to share tape revenue with NASDAQ market participants who report trades in New York Stock Exchange, Inc. ("NYSE") and Amex listed securities through NASDAQ.

NASDAQ EUROPE S.A./N.V.

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

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

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

NASDAQ EUROPE PLANNING COMPANY LIMITED

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

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

7. FAIR VALUE OF FINANCIAL INSTRUMENTS

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

8. BORROWINGS

SENIOR NOTES

On May 9, 2002, NASDAQ issued $150.0 million in aggregate principal amount of its 5.83% senior notes due 2007 (the "Senior Notes") in a private placement. The Senior Notes are unsecured, pay interest quarterly and may be redeemed by NASDAQ at any time, subject to a make-whole amount. The make-whole amount is equal to the excess of the discounted value of the remaining scheduled payments discounted at a factor equal to 50 basis points over the yield to maturity of U.S. Treasury securities having a maturity equal to the remaining average life of the redeemed amount. The proceeds from the Senior Notes, $149.0 million after payment of placement agent commissions and expenses of this offering, were used to fund a portion of the cash consideration paid to NASD in the repurchase and for general corporate purposes. Interest expense under the agreement totaled $5.6 million for the year ended December 31, 2002.

(Dollars in tables in thousands)

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

In May 1997, NASDAQ entered into a $25.0 million note payable with a financial institution (the "Lender"). Principal payments are scheduled to begin in 2007 and continue in equal monthly installments until maturity in 2012. The note requires monthly interest payments through May 2007 at an annual rate of 7.41%. After May 2007, NASDAQ will incur interest equal to the Lender's cost of funds rate, as defined in the agreement, plus 0.5%. Interest expensed and paid under the agreement totaled $1.9 million for each of the years ended December 31, 2002, and 2001.

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

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

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

SUBORDINATED NOTES

On May 3, 2001, NASDAQ issued and sold $240.0 million in aggregate principal amount of 4.0% convertible subordinated notes due 2006 (the "Subordinated Notes") to Hellman & Friedman Capital Partners IV, L.P. and certain of its affiliated limited partnerships ("Hellman & Friedman"). Until NASDAQ becomes registered with the SEC as a national securities exchange ("Exchange Registration"), Hellman & Friedman may only exercise its conversion rights for a number of shares of Common Stock such that immediately following such conversion, NASD will continue to control greater than 50% of the combined voting power of NASDAQ. NASDAQ used the proceeds from the sale of the Subordinated Notes to purchase 18.5 million shares of Common Stock from NASD for $13.00 per share. The annual 4.0% coupon will be payable in arrears and the Subordinated Notes are convertible at any time into an aggregate of 12.0 million shares of Common Stock at $20.00 per share, subject to adjustment, in general, for any stock split, dividend, combination, recapitalization or other similar event. On November 12, 2001, NASDAQ sold an aggregate amount of 500,000 shares of its Common Stock to Hellman & Friedman for an aggregate offering price of $5.1 million, which was the fair value at that date.

In 2002, NASDAQ stockholders approved an amendment to NASDAQ's Restated Certificate of Incorporation (the "Certificate of Incorporation") that provided for voting debt. As a result, the holders of the Subordinated Notes may vote on an as-converted basis on all matters on which holders of Common Stock have the right to vote, subject to the current 5.0% voting limitation in the Certificate of Incorporation. NASDAQ has granted Hellman & Friedman certain registration rights with respect to the shares of Common Stock underlying the Subordinated Notes.

On an as-converted basis, Hellman & Friedman owned an approximate 13.9% equity interest as a result of these Subordinated Notes in NASDAQ as well as 500,000 shares owned of Common Stock as of December 31, 2002. Hellman & Friedman is permitted to designate one person reasonably acceptable to NASDAQ for nomination as a director of NASDAQ for so long as Hellman & Friedman owns Subordinated Notes and/or shares of Common Stock issued upon conversion thereof representing at least 50.0% of the shares of Common Stock issuable upon conversion of the Subordinated Notes initially purchased. F. Warren Hellman, chairman of Hellman & Friedman, serves as a director of NASDAQ pursuant to this agreement.

(Dollars in tables in thousands)

9. INCOME TAXES

The income tax provision includes the following amounts:

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

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

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

The following represents the domestic and foreign components of income (loss) before income tax expense for the Company's taxable entities:

	YEARS ENDED DECEMBER 31, 2002	2001
Domestic	**$ 113,716**	$ 114,640
Foreign	**(29,539)**	(35,845)
Income before income tax expense and discontinued operations	**$ 84,177**	$ 78,795

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

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

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

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

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

10. EMPLOYEE BENEFITS

As of December 31, 2002, and 2001, the Company provided two non-contributory defined benefit pension plans and one non-contributory postretirement benefit plan for the benefit of eligible employees of its subsidiaries. The non-contributory defined benefit plans consists of a funded Employee Retirement Plan ("ERP") and an unfunded Supplemental Executive Retirement Plan ("SERP"). The benefits are primarily based on years of service and the employees' average salary during the highest 60 consecutive months of employment. The plan assets for the ERP plan consist primarily of fixed income and equity securities.

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