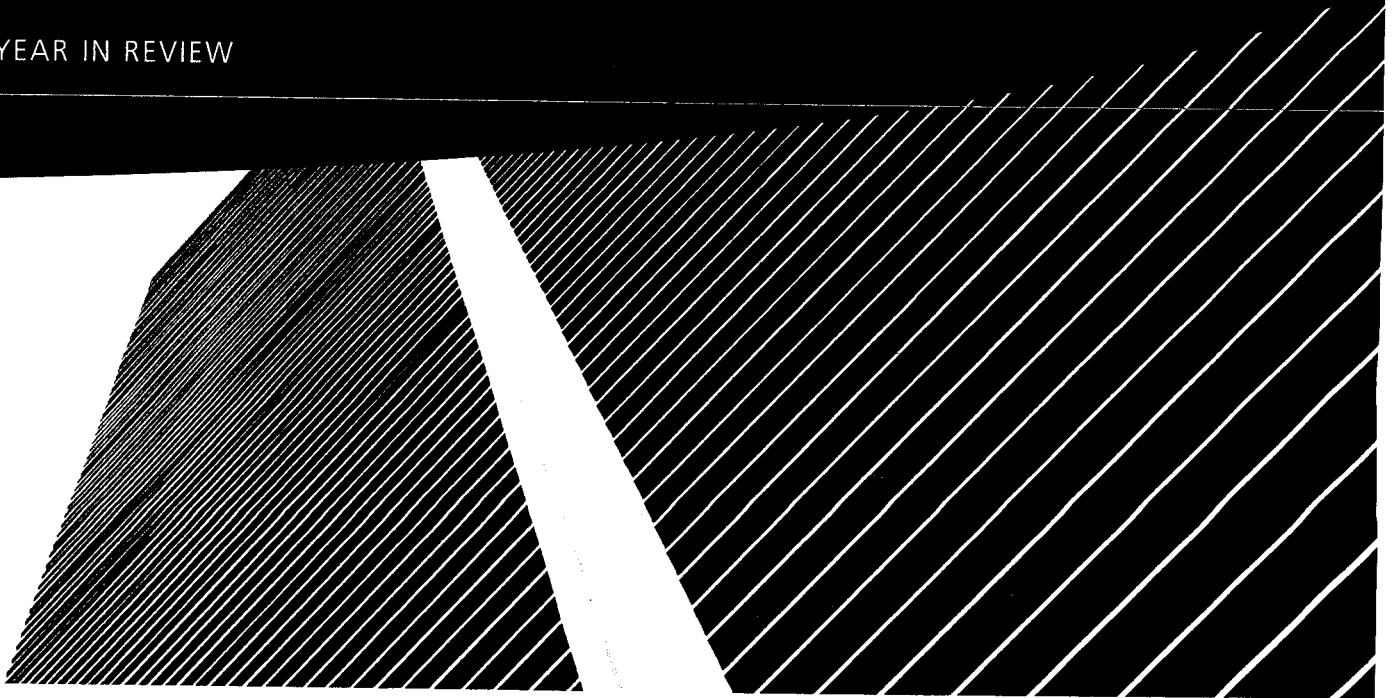


NASD™



2003 YEAR IN REVIEW



At NASD, our mission is clearer than ever:
to protect investors and bring integrity to the markets.

We're the world's leading private-sector provider of financial regulatory services, and every securities firm in the United States doing business with the public is overseen by NASD. The investing public is the driving force of the capital markets, and our staff of professional regulators operates entirely in their interest. We are governed by a Board of Governors comprised mostly of public and non-industry representatives. This makes us independent of the industry when it comes to fulfilling our regulatory mission on behalf of investors.



ROBERT R. GLAUBER
Chairman & Chief Executive Officer

Letter from the Chairman

NASD Works to ensure that when investors put their hard-earned dollars to work in the financial markets to pay for retirement, buy a house or fund their children's education, they are participating in a system that's fair and trustworthy. And for us, 2003 was a year of record-breaking accomplishments toward that goal.

During 2003 NASD wrote important new rules for the industry, launched an innovative Investor Education Foundation, expanded our Investor Forum education series and issued Investor Alerts on a range of issues important to investors at all levels. We expanded the range of bond transaction prices disclosed through TRACE, our system to provide transparency to the corporate bond market. And we launched important investigations into mutual fund industry sales practices. For example, we initiated an extensive review of mutual fund commission discounts – called breakpoints – that we project will result in the repayment of more than \$86 million to investors who were overcharged when they bought Class A mutual fund shares. At the same time, we further strengthened NASD's own corporate governance to assure that we meet governance standards at least as demanding as those imposed on listed, public companies.

As the world's largest private-sector regulator of financial services, NASD touches virtually every aspect of the securities industry. By law, every securities firm doing business with the American public must register with NASD. Today, about 5,400 brokerage firms and more than 665,000 stockbrokers and registered representatives fall under our jurisdiction. We register securities firms, write rules to govern their behavior, examine them for compliance and, when necessary, bring enforcement actions against those who break those rules. We provide, through NASD BrokerCheck, information on the professional background and disciplinary information about all registered firms and their brokers in the securities industry. We also operate the world's largest dispute resolution program, providing a neutral venue for resolving differences between investors and the industry, as well as between industry participants.

In 2003, we brought enforcement actions, suspended or barred brokers and dealers, conducted examinations and handled dispute resolution cases – all in record numbers. We also enhanced our ability to focus our resources on firms, individuals and activities more likely than others to harm investors.

Our work in 2003 included efforts to ensure that a broker did not recommend a stock that wasn't suitable to a customer's needs, that a firm did not promote one mutual fund over another in order to reap hidden benefits, and that conflicts that might taint research were exposed. We also strived to ensure that investors had all the information they needed to make informed decisions when they invested in stocks, bonds, mutual funds or other financial services products.

While we accomplished a lot in 2003, we know that ensuring market integrity is an ongoing endeavor. This report highlights a number of the accomplishments of 2003, and in so doing showcases the work of employees and people affiliated with NASD who are dedicated to investor protection. It also provides insight into the thinking of our senior management team and Board on how NASD should continue to evolve to meet changing needs. In reading it, I hope you gain a better understanding of NASD and our commitment to protecting investors and ensuring the integrity of the American capital markets.







CHARLES A. BOWSHER
Former Comptroller General
of the United States

SHARON P. SMITH
Fordham University Schools of Business

WILLIAM C. ALSOVER, JR.
Centennial Securities Company, Inc.

View from the Board

Charles A. Bowsheer:

I see NASD's corporate structure as a model of how self-regulation in the 21st Century can and should work. Divesting itself of NASDAQ and the American Stock Exchange will put NASD in a strong position to carry out its statutory mandate – to oversee and regulate the securities industry – without fear or favor. Moreover, having structured its Board of Governors so that most of its members are not affiliated with the industry allows NASD to say with confidence that it is an organization informed, but not directed or controlled, by the people and firms it oversees. It is a model for other self-regulatory organizations.

Sharon P. Smith:

In light of the many regrettable events – I am hesitant to use the word “aftermath” yet – that have stained the financial services industry in recent years, restoring investor confidence in the markets has to be Job One for all of us. If people think the game is rigged, they are going to stop playing. That is why tough, effective regulation and enforcement are critically important. Investors need to know that they are not alone, that someone with the power to make and enforce rules, and punish those who break them, is there, watching out for them. Erasing investors' skepticism about the integrity of the markets is going to take a lot of hard work. And NASD genuinely wants to help.

William C. Alsover, Jr.:

Many people's first experience with investing is with a small, local firm. These, with 150 or fewer sales representatives, comprise 92 percent of NASD's membership. People begin investing with a small firm because they feel more at ease and more comfortable there. Our customers are engineers, teachers and farmers – not professional stock-pickers. They are looking for guidance and advice. So, service and attention to the individual customer is vital. A very small number of firms, of all sizes, stepped over the ethical boundary and violated the public trust. The brokerage community will need to continue to heal itself and make it right for our customers. NASD has done a good job of fostering this process. They adhere to a rational, methodical process rather than writing rules based on the headlines. So, when they come to us with recommendations, they bring a rational, well-reasoned perspective.

Truth, when not sought after, rarely comes to light.

— OLIVER WENDELL HOLMES

EXAMINATIONS

Protecting investors requires constant vigilance, and NASD is continually improving and strengthening our examinations efforts – through more efficient business processes, the power of new technologies and systems, and the skill, experience and instincts of our roughly 600 examiners in the field.

We regularly examine all registered firms to determine compliance with federal securities laws and NASD rules. These regular examinations encourage firms to undertake initiatives that strengthen their own culture of compliance.


Our basic examination tool is the **routine examination**, and in 2003 we conducted more than 2,600 of them. These examinations are scheduled at three levels based on risk analyses: Level 1 examinations occur annually for all firms meeting criteria indicating a heightened risk of harm to investors and market integrity; Level 2 examinations for lower-risk, generally full-service firms occur every two years; Level 3 exams occur every four years and cover mostly small firms with good compliance records.

Cause examinations can focus on a questionable firm or broker. Any number of things can trigger a cause exam – a customer complaint, a regulatory tip, private litigation, referral from the SEC or another regulator, or a notice that a key individual at a firm has been terminated for cause.

Our examinations efforts rely heavily on the latest and most sophisticated technology. Our **National Examination Program and Financial Surveillance Systems** continually monitor various vital signs within a firm – such as net capital – that tell us whether the firm is healthy or may require heightened scrutiny or immediate on-site examination.

In 2003, NASD received widespread recognition for our work on the **mutual fund breakpoints** issue. This work actually began in 2001 with a routine examination of a small brokerage firm by our Philadelphia District Office staff. When we discovered that this firm had not given the required breakpoint discounts to investors, our examiners began to wonder if this was an isolated incident at one firm or if

it reflected a much broader problem throughout the industry. As a result, NASD convened a task force with the SEC and the New York Stock Exchange that examined the performance of 43 firms in providing breakpoint discounts. The task force reported in March 2003 that thousands of investors had not received the discounts they were owed when they bought mutual funds. Armed with this information, we took action: we directed about 450 securities firms to notify customers that they may be eligible for compensation owing to the firms' failure to provide breakpoint discounts. We ordered about 175 of those firms to comprehensively review their mutual fund sales since the start of 2001 to see if there had been other missed opportunities to offer discounts. We also undertook a national advertising campaign to alert investors to this issue, and we continue to work with the industry to correct the problem. So far, restitution to investors has topped \$33 million and we expect it will exceed \$86 million.



MUTUAL FUND BREAKPOINTS are discounts on up-front sales fees or front-end loads regularly offered for larger mutual fund investments, usually starting at \$50,000, but sometimes as low as \$25,000. Investors like Susan Blake of Alexandria, Virginia have learned that these breakpoint discounts can add up to significant savings. "When I saw NASD's advertisement last fall in *The Wall Street Journal* and *The Washington Post*, I thought the breakpoint discount might apply to my own fund purchases. The Investor Alert section of the NASD Web site provided me with all the information I needed to receive a breakpoint discount."

Susan Blake, Investor

EXAMINATIONS FOR CAUSE

| | |
|------|-------|
| 2003 | 3,384 |
| 2002 | 2,100 |
| 2001 | 1,841 |



A brokerage firm that engages in aggressive or self-serving SALES PRACTICES is tempting a visit from NASD enforcement professionals. In 2003, we saw two very similar cases in the area of mutual fund sales – one with a large securities firm and another with a small local brokerage house. Both firms held in-house sales contests to promote certain favored investment products. “Trips to Las Vegas and the Caribbean, big-screen TVs, even tickets to Rolling Stones and Britney Spears concerts were some of the perks offered to the top sellers at each firm,” comments NASD Regional Counsel Jon Batterman, who helped break the cases. In the end, the large firm paid \$2 million in civil penalties, one of the most significant fines ever imposed in a mutual fund sales case. The smaller firm was fined \$100,000. “These types of sales contests are highly problematic because they may encourage brokers to place customers into investments based on the financial incentives to the broker rather than the best interests of the customer,” Batterman says.

Evan Gordon, Linda A. Walters, Jon S. Batterman, Enforcement, NASD

**BROKERS BARRED/SUSPENDED
2003**

| |
|------------|
| ██████████ |
| ██████████ |
| ██████████ |

**FIRMS EXPELLED/SUSPENDED
2003**

| |
|------------|
| ██████████ |
| ██████████ |
| ██████████ |

ENFORCEMENT

Vigorous, fair and effective enforcement of securities laws and regulations remains a cornerstone of NASD's practices.

We are able to play a major role in fighting for investor protection and market integrity because we have significant statutory authority. The roughly 5,400 brokerage firms and 665,000 stockbrokers and registered representatives doing business with the investing public come under our jurisdiction. When firms or individuals break the rules, we can fine them, suspend them, even bar them from the industry forever.

In 2003, we set a record for both the number of **new enforcement actions filed** – 1,410 – and the number of **individuals suspended or banned** from the securities industry – 827 – for violating securities rules and laws. NASD also collected more than \$33 million in disciplinary **fin**es.

NASD focused its efforts on many of the issues that were important to the investing public. The **mutual funds** market has seen huge growth in popularity, but some funds have recently been cited for violations. NASD has jurisdiction over how mutual

funds are sold by brokerage firms, and we have concentrated on several pertinent issues, including deceptive sales practices by brokers; whether the mutual fund share classes that brokers recommend are the right choices for their customers; the clarity and accuracy of brokers' cost disclosures to investors; cash and non-cash compensation brokers get for favoring particular funds; and whether brokers give customers appropriate discounts on large-volume purchases of mutual fund shares. We brought more than 60 enforcement cases relating to mutual funds in 2003, and more than 200 during the last three years.

We also focused on the role of brokers and firms in late trading and market timing of mutual funds. We examined more than 160 firms' late-trading and market-timing practices – and we found that a number of them clearly had problems in these areas. NASD Enforcement has already brought cases addressing these practices and continues to pursue a number of investigations.

We also addressed problems with variable annuities on a number of fronts. We established a corporate-wide task force to look into sales practices, brought dozens of cases and conducted exams in a broad industry sweep.

Our strategic approach to enforcement further enabled us to identify investor protection issues in new areas of concern – such as 529 college savings plans and hedge fund marketing and advertising. An important part of this approach was improved technologies, including powerful forensic investigative technology that helped focus our investigations and bring cases more quickly.

At NASD, we simply can't wait for these types of cases to come to us – we need to bring cases more quickly and aggressively, and put those we regulate on notice that violations in these key areas will not be tolerated.

It takes twenty years
to build a reputation,
and five minutes to ruin it.

— WARREN BUFFETT



Information is power in today's fast-moving marketplace, and NASD is constantly finding new ways to empower investors with accurate PRICING INFORMATION. "It's all about transparency," says Justin Tubiolo of the TRACE team. "For the first time, bond investors can make decisions based on publicly available benchmark pricing information, just like equity investors." If further proof were needed of the power of TRACE technology, one member of Justin's team reported educating his own professional broker as to the best price on a corporate bond transaction; "I think the broker was a little surprised both that an individual investor had access to this kind of information, and how many bonds the TRACE dissemination universe covered."

Justin J. Tubiolo, Patricia A. Casimates, TRACE, NASD

TRACE CORPORATE BOND VOLUME

2003 1.52 trillion

TRACE CORPORATE BOND TRADES

2003 16.7 million

MARKET TRANSPARENCY

Transparency in pricing is one of the main principles that support a healthy and efficient marketplace. At NASD, we have made market transparency a cornerstone of our mission to promote complete disclosure across the financial services industry.

In 2002, NASD introduced a revolutionary new system that brings transparency to the corporate bond market – the **Trade Reporting and Compliance Engine (TRACE)**. In 2003, the number of corporate bonds reported to the public through TRACE increased nearly tenfold – from 550 to 4,650. This represents

approximately **68 percent of the investment-grade corporate bond market volume**. In 2004, virtually 100 percent of corporate bonds traded – more than 23,000 – will be reported to the public immediately.

There are powerful trends moving retail investors into corporate bonds – once the exclusive preserve of institutional investors. TRACE information represents a great leap forward, opening a window onto the formerly opaque corporate debt market that investors and regulators have never seen before.

In addition to giving investors benchmark pricing in this market, TRACE data shows regulators that retail investors are active participants in the corporate bond market at every level of credit quality. The data also reveals that approximately **65 percent of corporate bond trades** are being made in retail-sized purchases of less than \$100,000.

As greater numbers of retail investors move into corporate debt the importance of TRACE will only grow.

Information is the oxygen
of the modern age.

— RONALD REAGAN

An investment in knowledge pays the best interest.

— BENJAMIN FRANKLIN

EDUCATION

At NASD, it is our belief that understanding should precede investing – and that education is often the best form of investor protection. As greater numbers of investors turn to the markets to fund their retirements, pay for college or purchase a home, education has become a vital part of our work.

To this end, NASD offers a broad range of tools and programs to help people better understand investing and to know how to protect themselves along the way.

Several of our pioneering investor education programs help the public understand the basics of investing – as well as the latest investment vehicles that will help them meet their goals. In 2003, NASD significantly expanded its **Smart Investor** series with new on-line learning centers covering both 401(k) and 529 college savings plans. Our new on-line **\$29** and **Mutual Fund Calculators** also help investors compare the costs of various classes of mutual funds with the click of a mouse.

Our **Investor Alert** series continued in 2003, with seven new alerts on topics ranging from Variable Annuities and Mutual Fund

share classes to the implications of borrowing money to invest in securities. The Investor Alerts page on NASD's Web site delivers much more than caution – it gives investors a single touch-point for critical information about some of the most important issues affecting investors today. It also provides practical, easy-to-use tools for investors to apply that information to their own individual financial circumstances and decisions.

Six investor forums were conducted around the country in 2003, including one in Baltimore, Md., which was covered by the press. When you've heard about something from NASD, you've heard it first. Our focus is on a range of investment topics and regulatory issues.

Our **Understanding Professional Designations** database also went live in 2003. This on-line tool helps investors navigate the maze of professional credentials used by financial industry participants. Furthermore, a record 2.5 million requests for information on brokers' qualifications were handled with the help of the newly enhanced NASD **BrokerCheck** system.

NASD will continue to play a vital role in improving investor literacy. In our first-ever investor literacy survey, conducted in the Spring of 2003, we found that the majority of investors had little familiarity with basic investing principles. The survey also revealed that only 23 percent of investors with household incomes below \$50,000 understood the basic principles.

To address this clear need for improved investor literacy, the **NASD Investor Education Foundation** was formed in November 2003. The foundation will fund and coordinate research and education programs targeting women, young adults and lower income investors, among others. Additionally, have been our key focus. "Investor information is critical, and investors have received that information," says John Gannon of NASD's Office of Investor Education, "and we're continuing our efforts to bring the information and the tools they need directly to them, so they can understand better and invest."



Several times a year in cities and towns across America, NASD INVESTOR FORUMS bring together members of the public like Robin Meyer Michel of Ortonville, Michigan, and top NASD officials to talk about investing and regulation. The Forums present a unique opportunity for NASD executives and staff to meet face-to-face with investors and hear their views of the market. "Like a lot of people, I lost part of my savings when the market dropped in 1999 and 2000," Robin says. "Learning that NASD was there to watch out for smaller investors like me helped me regain my confidence and get back into the market. Their vigilance and their efforts to reach out to investors have been enormously reassuring."


Robin Meyer Michel, Investor

INVESTORS WHO FELT THEY NEEDED
TO KNOW MORE ABOUT INVESTING*

97%

*From the 2003 NASD INVESTOR LITERACY
survey, conducted by Applied Research
& Consulting LLC





ARBITRATION AND MEDIATION are the pillars of NASD's Dispute Resolution effort. Arbitrators consider testimony and evidence, judge the facts and ultimately are empowered to make a decision. "You have to be neutral, independent and absolutely free from conflict," insists Professor Constantine Katsoris of Fordham Law School, who has served as an NASD arbitrator and mediator for more than 35 years. "As a mediator, there are no clear rules except firmness and a sense of humor. You are trying to bring the parties together, to keep them talking until we bridge the gap. In a recent mediation, I was the one average-sized person sitting between two ex-Olympic rugby players, 280-pound former teammates who now worked in the securities industry and had ended up on opposite sides of a tense dispute. When these men settled and shook hands, I was more than a little relieved."

Constantine Katsoris, J.D., Fordham University School of Law

ARBITRATION CASES FILED

2005 5,975

MEDIATION CASES FILED

2005 1,144

DISPUTE RESOLUTION

Fairness and neutrality are at the heart of public trust in the markets. And because investors sometimes need the intervention of a neutral third party in resolving disputes that arise with their brokers, NASD operates the world's largest securities dispute resolution forum.

Mediation is an informal, voluntary process in which a professional mediator facilitates negotiations between parties, helping them arrive at their own acceptable resolution. The **arbitration** process determines whether a party is entitled to recover damages. An impartial person or panel hears all sides of the issue, studies the evidence and then decides how the matter should be resolved. Arbitration is final and binding, and subject to court review only on a very limited basis.

Mediation or arbitration is almost always faster and less expensive than litigation. More than 50 percent of claims are settled between the parties either directly or through mediation. Of the investor cases decided by arbitrators, more than half result in an award in favor of the investor.

In 2003, NASD arbitrators awarded approximately \$162 million to investors.

In 2003, NASD Dispute Resolution had its third consecutive record year with more than **8,900 new cases** filed in its arbitration forum – a 16 percent increase over the 2002 level of 7,700, and a nearly 30 percent increase over the 6,900 new cases opened in 2001.

As the number of cases has increased significantly, dispute patterns have also emerged. Our data show that the leading point of contention in each of the last three years has been a claim that a stockbroker or firm breached its fiduciary duty to an investor. Other common areas of dispute involve misrepresentation or failure to supervise. And, while stock transactions are by far the most common types of securities involved in NASD arbitration cases, our arbitration panels are also considering an increasing number of claims involving mutual funds as well as disputes involving corporate bonds and stock options.

In addition to these arbitration cases, we closed almost 1,900 mediation cases, a record number. In three separate instances this year, parties successfully used mediation to settle a large group of related cases. These settlements added to the total number of cases mediated and helped to boost the overall settlement rate to 83 percent.

With caseloads increasing, NASD added new Dispute Resolution teams throughout the country in 2003. We have also developed a comprehensive plan to address additional anticipated increases by adding approximately 500 new arbitrators and streamlining arbitrator training.

NASD Dispute Resolution continued opening new hearing locations and scouting for new sites. Our goal is to have at least one hearing location in every state by the spring of 2005.

Fairness is what justice really is.

— POTTER STEWART



At one time HEDGE FUNDS were niche products that investment professionals offered on sophisticated investors. Today, hedge funds are faced with the "retailization" of hedge funds. This gives rise to well-heeled and less well-heeled hedge fund investors. This gives rise to some new suitability issues. "We've never said that we're doing enough to protect investors," says Gary L. Goldsholle. "The Ahead of the Curve is a hedge fund. In 2003, we worked closely with identifying firms that were marketing these products to retail investors. It was to ensure that firms understand the nature and risks of hedge funds and that they add to investors equipped to tolerate the risks."

Gary L. Goldsholle, Maryel Sterling, Regulatory Director, O'Connell & Associates

BROKER/DEALER STATEMENTS AND REPORTS

| | |
|-------|------------------|
| 2003: | over 2.8 million |
| 2002: | over 2.2 million |
| 2001: | over 1.8 million |

Nothing is permanent but change.

Investment trends come and go and an evolving marketplace demands a regulator who can adapt quickly to new circumstances. Our Ahead Of The Curve Task Force, established in 2002, continues to take important steps in our ceaseless endeavor to anticipate, identify and respond promptly to emerging issues.

In 2003, the Task Force got out in front of several emerging issues of concern, such as the sale and marketing of 529 college savings plans, pledged-asset mortgages, bonds and bond fund investing.

The Task Force is continually searching for and adding new issues to those already under analysis. Issues added in 2003 include the use of home mortgage proceeds to invest in securities, practices associated with sales of hedge funds and registered products that invest in them, and practices associated with sales of non-conventional instruments, such as asset-backed securities and derivatives.

Once the Task Force has identified new issues that require attention, we may take a variety of responsive steps. They might include traditional approaches, such as bringing enforcement cases and writing rules and interpretations. Or, they can include surveying firms, publishing best

practices, or promulgating new rules. In 2003, we published a guidance document on compliance with NY 17a-9 and addressed investor information issues to investors.

As we have always said, we will continue to change and markets will continue to evolve. In addition to our responsibilities for enforcement, dispute resolution, examination and education, NASD is continually looking for and identifying and addressing emerging and potential problems in the hope of heading them off. The goal is to help investors reach their journey before their initial investments in the capital markets has been disrupted. This has become a key part of NASD's general operating procedure.

A case in point is our effort to make sure that market timing abuses, which have become infamous in the mutual fund industry, do not spread to the deferred variable annuity sector. Another is our commitment to bringing greater transparency to the corporate bond market, now that more and more individual investors are wading into it.

In the long term, it will never be profitable for a firm to do the business by breaking the rules. To get ahead, the system may bring short-term profits, but firms that do it risk

much more than they gain. In fact, they risk their reputation and we recognize that investor confidence is the lifeblood of the market. It is important to the industry's health.

NASD is committed to ensuring that firms doing business with the investing public understand their fiduciary duties and resolve conflicts with investors in a manner that comports with high standards of commercial honor, fair and equitable principles of trade. This means a commitment by firms and their officers to doing the right thing, even when there is no law or regulation that directly applies to the situation at hand. Public confidence and willingness to invest in the securities markets rest on the notion that those markets are fair, orderly and transparent. These principles are at the heart of NASD rules and federal securities laws, which heavily emphasize disclosure. Investors have the right to expect that any risks they take are consequences of market fluctuations that are inherent parts of investing, not of broker dishonesty or carelessness. At NASD, we are committed to upholding and protecting that right.



An Inside Perspective

Keeping Focused on the Mission

"In light of the events of the last few years, it is crucially important that NASD remains strong and resolute in its oversight of the securities industry. To do this we must set clear and appropriate rules and enforce them rigorously but consistently. And we must continue to review our rules to ensure that they are not out-of-date. In this way we put an emphasis on protecting investors, while recognizing the need for a healthy, competitive industry."

Robert R. Glauber
Chairman and
Chief Executive Officer

Protecting Investors

"When we talk about protecting investors, we don't just mean punishing brokers and firms that break the rules and abuse their clients' trust. That's an important part of our mission, but investor protection entails much more. It is understanding how the financial industry is changing through evolving trading methods and new products and services – and anticipating potential problems so as to prevent them. And it's providing clear, useful and accessible investor education resources for investors and industry professionals. Simply put, investor protection means making sure investors know that someone is watching out for them and protecting their interests."

Mary L. Schapiro
Vice Chairman and President,
Regulatory Policy and Oversight

Providing Education and Compliance Support to Firms

"As the business environment changes, NASD needs to innovate to support market integrity. One of our innovative strategies is to help firms execute their front-line compliance duties. Our seminars and conferences conducted around the country are examples of this proactive approach. We recently expanded these programs by adding a Small Firm Conference series and by launching the on-line NASD Report Center, where brokers and firms can review information about their compliance performance. Helping firms run a clean operation is one innovative approach to protecting investors."


Douglas H. Shulman
President, Markets, Services
and Information

Fostering the Mission from Within

"We operate in a constantly changing regulatory environment, so it's not enough for us just to react to emerging issues and trends; we need to anticipate them, to be ahead of the curve. This capability is at the heart of NASD's strategic vision. And it is a motivating factor for our employees. Our people come to us from a wide range of backgrounds – the securities industry, law, government and other disciplines. What we all share is a culture of respect – for the people we protect, for the people we regulate and, most importantly, respect for one another."

Michael D. Jones
Senior Executive Vice President
and Chief Administrative Officer

NASD OPERATIONAL & FINANCIAL HIGHLIGHTS



NASD's focus on its regulatory mission of investor protection and market integrity has never been more important than it was in 2003, as investors continued to be skeptical in the face of well-publicized abuses in the securities and mutual fund industries. NASD was resolute in dealing with problems, setting a record for the number of enforcement actions, bars and suspensions, and claims filed in its Dispute Resolution division. Rule writing was also an important focus of the organization, especially in the areas of analyst conflicts of interest and initial public offerings. NASD vastly expanded information regarding the corporate debt market through the Trade Reporting and Compliance Engine (TRACE).

Operational Highlights

The following statistics provide a snapshot of the role NASD plays in helping to protect investors and bring integrity to the markets. All statistics are for the calendar year 2003.

| | |
|----------------------------------|---------|
| Broker-dealers regulated by NASD | 5,392 |
| Broker-dealer Branch Offices | 91,473 |
| Registered Representatives | 662,311 |
| NASD employees | 2,100 |

INVESTOR COMPLAINTS

| | |
|------------------------------|-------|
| Customer complaints received | 4,843 |
| Customer complaints resolved | 5,686 |

NASD BROKERCHECK

NASD BrokerCheck 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 2.8 million |
| Reports generated | 184,404 |

REGULATORY ACTIONS

| | |
|--|--------|
| Firms expelled from the industry | 30 |
| Firms suspended | 7 |
| Individuals barred from the industry | 494 |
| Individuals suspended | 333 |
| New disciplinary actions filed | 1,410 |
| Formal actions resolved | 1,324 |
| Advertisements and sales communications reviewed | 85,737 |

TESTING AND CONTINUING EDUCATION

Qualification Exams

| | |
|------------|---------|
| NASD Exams | 129,309 |
| Other | 113,090 |

| | |
|-------------------------------|---------|
| Continuing Education sessions | 189,956 |
|-------------------------------|---------|



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.

| | |
|---|-----------------------------|
| Corporate bond volume reported to the system | 5.2 trillion dollars |
| Corporate bond trades reported to the system | 6.7 million trades |
| Percent of investment grade volume reported to the public | 68% |
| Percent of investment grade trades reported to the public | 61% |

MARKET SURVEILLANCE

Each trading day, NASD monitors some 109 million quotes, orders and trades. In the calendar year 2003, NASD monitored about 1.6 trillion shares reported to NASDAQ and the Alternative Display Facility (ADF) for Small Cap, CQS, OTC and OTCBB.

CORPORATE FINANCING

| | |
|-------------------------|------------|
| Equity filings | 508 |
| Debt filings | 87 |
| Other corporate filings | 51 |
| Total corporate filings | 646 |
| Other filings | 107 |
| Grand total | 753 |

DISPUTE RESOLUTION

Arbitration

| | |
|--------------|--------------|
| Cases filed | 8,945 |
| Cases closed | 7,278 |

How arbitration cases were closed:

| | |
|----------------------------------|--------------|
| Closed after hearing | 1,764 |
| Closed after review of documents | 313 |
| Settled by the parties | 2,616 |
| Settled by mediation | 1,182 |
| Withdrawn | 647 |
| All other* | 679 |

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

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

Mediation

| | |
|---------------|--------------|
| Cases brought | 1,144 |
| Cases closed | 1,889 |
| Cases settled | 1,570 |

Financial Highlights

NASD's financial performance in 2003 was favorable throughout the year. The results exceeded expectations and remained in line with prior years. Strict cost controls kept operating expenses under budget, in spite of the increased volume and scope of our activities.

The financial information provided herein represents the results of operations of the NASD business segment excluding the operations

of NASDAQ and the loss on disposal of the Amex. Refer to NASD's Annual Financial Report for NASD's 2003 Consolidated Financial Statements and Management Report on Financial Operations. www.nasd.com/corp_info/financials.asp

OPERATING RESULTS

NASD's operating revenues were \$472.0 million in 2003 compared with \$450.4 million in 2002, an increase of \$21.6 million or 4.8%. Operating expenses increased \$15.3 million, or 3.0%, to \$518.1 million in 2003. As a result, cash flow, as measured by earnings

before interest, taxes, depreciation and amortization (EBITDA) less fines remained relatively constant at (\$1.7) million and \$2.3 million in 2003 and 2002, respectively.

NASD OPERATING RESULTS (IN MILLIONS) YEARS ENDED DECEMBER 31

| | 2003 | 2002 |
|---------------------------------|------------|------------|
| Operating Revenues ¹ | \$ 472.0 | \$ 450.4 |
| Expenses | \$ (518.1) | \$ (502.8) |
| Contribution Margin | \$ (46.1) | \$ (52.4) |
| Depreciation and Amortization | \$ 44.4 | \$ 54.7 |
| Cash Flow (EBITDA) | \$ (1.7) | \$ 2.3 |

¹Excludes fines of \$33.3 million and \$68.2 million in 2003 and 2002, respectively. Fines represent sanctions collected for rules violations, which NASD does not view to be part of operating revenues.

NASD FINANCIAL SUMMARY (IN MILLIONS)

| | | |
|---------------------|------------|------------|
| Operating Revenues | \$ 472.0 | \$ 450.4 |
| Expenses | \$ (518.1) | \$ (502.8) |
| Contribution Margin | \$ (46.1) | \$ (52.4) |
| Cash Flow (EBITDA) | \$ (1.7) | \$ 2.3 |

■ 2003
■ 2002

OPERATING REVENUES

Member regulatory fees were \$175.4 million in 2003 compared with \$177.5 million in 2002, a decrease of \$2.1 million or 1.2%. Member regulatory fees include the transaction-based Trading Activity Fee, as well as assessments based on the gross income and number of personnel of member firms. These fees are used to fund NASD's member regulatory activities, including the regulation of members through examinations, processing of membership applications, financial monitoring, policymaking, rulemaking and enforcement activities.

Contract services fees represent amounts charged by NASD to NASDAQ for conducting surveillance monitoring, and legal and enforcement activities. Contract services fees totaled \$61.9 million in 2003 compared with \$76.7 million in 2002, a decrease of \$14.8 million or 19.3%.

The decrease was primarily due to reductions in technology costs from improvements and cost allocation refinements.

OPERATING REVENUES (CONT'D)

Registration fees were \$65.8 million in 2003 compared with \$69.6 million in 2002, a decrease of \$3.8 million or 5.5%. Dispute resolution fees experienced a record year totaling \$75.5 million in 2003 compared with \$59.6 million in 2002, an increase of \$15.9 million or 26.7%. In 2003, almost 9,000 new cases were filed in NASD's arbitration forum, representing an increase of 1,241 cases or a 16.1% increase from the number of cases filed in 2002. An additional 202 cases were filed directly in mediation, which is down from 275 in the previous year.

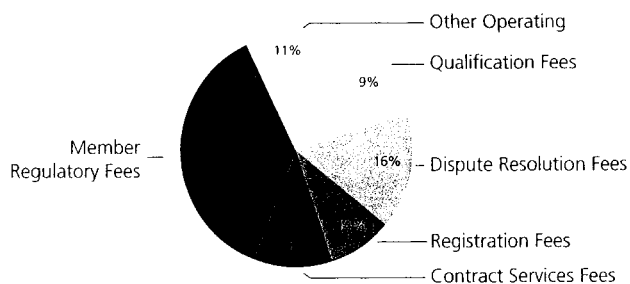
Qualification fees remained relatively constant based on static registered representative populations and testing volumes. Qualification fees totaled \$40.4 million in 2003 compared with \$37.7 million in 2002, an increase of \$2.7 million or 7.2%.

Other revenues increased to \$53.0 million in 2003 compared with \$29.3 million in 2002, due mainly to (a) the revenues associated with the launch of ADF in late 2002 and (b) the full-year operation of the TRACE program in 2003, which was approved by the Securities and Exchange Commission and became operational in July 2002.

NASD OPERATING REVENUES BY YEAR (IN MILLIONS) YEARS ENDED DECEMBER 31

| | 2003 | 2002 |
|-------------------------|----------|----------|
| Member Regulatory Fees | \$ 175.4 | \$ 177.5 |
| Contract Services Fees | \$ 61.9 | \$ 76.7 |
| Registration Fees | \$ 65.8 | \$ 69.6 |
| Dispute Resolution Fees | \$ 75.5 | \$ 59.6 |
| Qualification Fees | \$ 40.4 | \$ 37.7 |
| Other Operating | \$ 53.0 | \$ 29.3 |
| Operating Revenues | \$ 472.0 | \$ 450.4 |

2003 NASD OPERATING REVENUES



EXPENSES

Increases in operating expenses from last year are primarily the result of increases in compensation and benefits expense due to an increase in Dispute Resolution and

Technology personnel. This increase was partially offset by declines in professional and contract services due to technology cost improvements.

NASD EXPENSES BY YEAR (IN MILLIONS) YEARS ENDED DECEMBER 31

| | 2003 | 2002 |
|---|----------|----------|
| Compensation & Benefits | \$ 267.8 | \$ 234.0 |
| Professional & Contract Services | \$ 119.6 | \$ 134.1 |
| Computer Operations & Data Communications | \$ 19.1 | \$ 19.7 |
| Depreciation & Amortization | \$ 44.4 | \$ 54.7 |
| Occupancy | \$ 30.1 | \$ 24.0 |
| Other | \$ 37.1 | \$ 36.3 |
| Total Expenses | \$ 518.1 | \$ 502.8 |

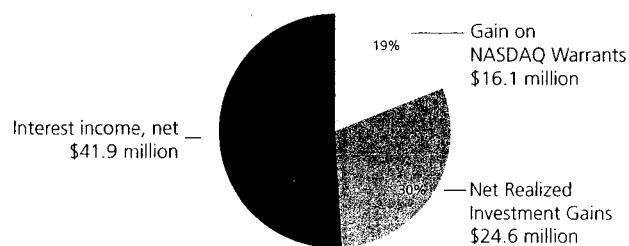
Financial Highlights (cont'd)

OTHER INCOME (EXPENSE)

NASD total other income was \$82.6 million in 2003 compared with \$94.1 million in 2002, a decrease of \$11.5 million or 12.2%. Included within other income (expense) are interest income,

realized gains (losses) on investments, and the mark-to-market adjustment related to warrants issued by NASD to purchase NASDAQ common stock.

2003 NASD OTHER INCOME YEAR ENDED DECEMBER 31, 2003



BALANCE SHEET

Total assets for NASD have remained relatively consistent year after year at approximately \$1.6 billion. Working capital as of December 31, 2003 remained strong at \$961.6 million, up from \$799.5 million over prior year-end.

Equity – NASD's equity position continues to remain strong totaling \$1.2 billion.

NASD SUMMARY BALANCE SHEET (IN MILLIONS) YEARS ENDED DECEMBER 31

| | 2003 | 2002 |
|---------------------|------------|------------|
| Current Assets | \$ 1,415.9 | \$ 1,210.1 |
| Other Assets | \$ 245.1 | \$ 425.5 |
| Total Assets | \$ 1,661.0 | \$ 1,635.6 |
| Current Liabilities | \$ 454.3 | \$ 410.6 |
| Other Liabilities | \$ 49.8 | \$ 50.4 |
| Total Liabilities | \$ 504.1 | \$ 461.0 |
| Equity | \$ 1,156.9 | \$ 1,174.6 |

NOTE: Total assets and equity include NASD's investment in NASDAQ and Amex under the equity method of accounting.

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