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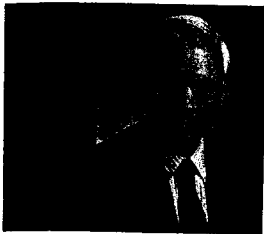
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THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

CONSOLIDATED FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2000 AND 1999

WITH REPORT OF INDEPENDENT AUDITORS

LETTER FROM THE CEO AND PRESIDENT



Ordinarily, CEOs use letters such as this one to tout their company's accomplishments during the preceding year. And 2000 was surely a year of achievement and progress for the NASD®. But this is no ordinary time for our Association. The spin-off of The Nasdaq Stock Market® gives us new independence, resources and focus. During this pivotal time of transition, I want to convey clearly the historic responsibilities we bear, the new opportunities we face, and the strategic goals we will pursue in the months and years to come.

Nasdaq Restructuring

In April 2000, the NASD's members overwhelmingly approved our plan to spin off Nasdaq®. Today, this momentous step is on track and bound for completion. We have reduced the NASD's ownership interest to 27.6 percent, on a fully diluted basis.

Our goal is to fully separate the NASD from Nasdaq. This is the right course for both companies as well as our membership. As Nasdaq moves off on its own, all of us are proud of the NASD's role over the years in helping to build the premiere stock market on earth. And we are grateful for the vision and leadership of Frank Zarb over the last half decade.

We plan to sell off our remaining minority position in Nasdaq in an expeditious yet orderly fashion. This will allow the NASD to focus on our primary mission: fostering the most efficient, liquid, transparent and fair securities markets in the world – so that investors trust and use our markets.

Self-Regulation and Market Integrity

The unique system of self-regulation enjoyed by the U.S. securities industry should never be taken for granted. When Senator Maloney proposed it in 1938, he said the goal was to create a system "in which the members of the industry will themselves exercise as large a measure of authority as their natural genius will permit." By any fair measure, the ensuing division of labor has been a story of success.

During the more than six decades since the Maloney Act, our industry has earned a major share of self-regulatory authority – and investors worldwide have flocked to our markets. These two trends are no mere coincidence. Self-regulation brings to bear a keen practical understanding of the industry. It fosters high standards and member involvement. And it has helped to make our markets the envy of the world.

The NASD has an indispensable role to play in sustaining and strengthening this system. Our spin-off of Nasdaq will put us on a sounder footing to do so. For we know that we must never neglect our core

competence and central duty to be a tough and even-handed regulator. This is our statutory responsibility. It is our historic identity. And it is the polestar by which we will always navigate.

In this time of turbulence and testing, such duties are more important than ever. Under the leadership of Mary Schapiro, our NASD Regulation® subsidiary has maintained the highest standards of investor protection and professional excellence. And NASD Dispute Resolution, guided by Linda Fienberg, has expanded and enhanced our mediation services.

But the NASD's distinctive role demands even more than the vigilant pursuit of investor protection and market integrity. It requires us to understand that we are a private-sector regulator, not a government regulator – and to act accordingly.

That means closely scrutinizing both the burdens we impose and the costs we incur. It means taking every appropriate step to see that our behavior is businesslike, not bureaucratic. It means developing and applying a sophisticated understanding of what it is like to operate on the other side of the regulatory fence. It means, in short, reaffirming the “self” in self-regulation.

We are taking major strides to make this streamlined vision a reality. For instance, we are developing the INSITE system to better focus our resources and examiners. Our field examinations should be based on compliance risk, not only the calendar. Last year, we revamped several major rules and migrated ten filing systems to the Web. And this year, we are conducting a systematic, no-holds-barred review of all our regulations – existing and prospective – to ensure that they yield the maximum benefit for the minimum burden. I cannot promise a particular result at the end of this effort. But the process itself is a healthy one. For our members, it will mean rules that are better justified and better crafted. And for us as regulators, it will permanently influence our mindset and methods.

Another new direction we are taking may represent our most ambitious initiative, and its success is anything but assured. But it is the next logical step in our evolution. And it is the right step to try, because the benefits for our members and the public could be substantial. We have undertaken a serious effort to see if there are ways to employ more broadly the NASD's unique skills, technology and brand name as the leading private supplier of market integrity services in the world. This includes discussions with other regulators, markets and exchanges – abroad as well as at home – regarding the potential usefulness to them of our regulatory services, expertise and technology. Such discussions are helping us determine how much of a market may exist for such services.

To whatever extent our new business efforts can succeed, the public, the NASD and our members all stand to gain. By earning an acceptable rate of return, we can hold down the cost of our services to our membership. By seeking to win and hold on to new clients – who would voluntarily choose our services – we can learn to better serve our existing markets and members. And we will benefit from facing the same market discipline that our members must face every day.

All these efforts and others are premised upon a key assumption: namely, that the overwhelming majority of members of our industry want to abide by the rules and the law. This is not naïve faith, but hard-headed fact. For our members understand that market integrity leads to investor confidence, which leads to more business. And they view their own reputation for fair dealing and high standards as a competitive advantage in a competitive industry.

This leads us to a related principle, which is that if self-regulation is a good thing, then self-compliance is desirable as well. That is not code for relaxing our standards or being less vigilant. But it does mean we want to spend less time calling unintentional fouls, so we can focus more of our energy and resources on the high-risk, high-stakes issues that can undermine public confidence in our industry and our markets. And it means that if technology can help the industry to detect and deter more of its own violations, then as self regulators we are committed to exploring such possibilities.

Make no mistake. None of this will ever lead us to compromise our regulatory mission. To the contrary, we are very clear that if our new emphasis on streamlined, private sector methods ever comes into conflict with this mission, it is our regulatory responsibilities which are sacred and must prevail. We are pursuing businesslike methods and opportunities not to become a for-profit business, but to become a more effective, private sector, self-regulatory organization. Simply put, we are taking these steps not to stray from our historic mission, but to carry out that mission better than ever.

American Stock Exchange

The American Stock Exchange® achieved strong growth in all three lines of its business last year. Listings of exchange-traded funds (ETFs) and HOLDERSSM increased almost three-fold, while assets and volume nearly doubled for the sixth consecutive year. Equities listing rose substantially, and the Amex Composite Index outpaced most other broad-based indexes. On the options side, volume surged past 200 million contracts – giving the Amex® the largest market share increase of any domestic exchange.

As the Amex moves forward, it is focusing on two key areas for growth and innovation: creating a global trading platform for ETFs and investing in technology. The Amex is extending its global leadership in ETFs through joint ventures with influential partners such as the Tokyo Stock Exchange, the Singapore Exchange and Euronext. In technology, the Amex successfully made the switch to decimal trading in January 2001, and completed a major expansion of the trading floor in May 2001. Other major initiatives include installation of a fully electronic, screen-based options trading platform; a new booth automated routing system to further improve the speed and handling of orders; and a new equity trading platform for ETFs.

Looking further down the road, as top Amex and NASD officials have publicly stated, the Amex should be independent of the NASD. When the time comes, the Amex and NASD Boards will work together closely on a process and timetable by which we achieve independence for the Amex.

Meanwhile, the Amex will concentrate on continuing its strong track record of innovation and on meeting the challenges of a constantly changing and increasingly competitive environment in each of its business lines. Under the leadership of Sal Sodano, this philosophy has been the cornerstone of the Amex's revitalization.

Sound Management and Prudent Investments

In a time of reduced margins for our industry, I have made it my priority to ensure that the NASD is managed in an efficient and businesslike way. That means investing our funds wisely. And it means scrutinizing carefully both the burdens we impose and the costs we incur.

In light of last year's exceptional performance, we have made a concerted effort to reduce member costs. We enacted significant fee reductions, volume discounts, and rebates for members in 2000. Going forward — assuming a sufficient number of the Nasdaq warrants are exercised — the NASD is committed to reducing its membership fees by an additional \$107 million through 2006.

Financially, NASD posted another record year in 2000. The very active securities markets helped us earn consolidated revenues, including Nasdaq, of 25 percent above 1999. Net operating income increased 44 percent. These strong financial results enabled us to increase our already extensive investments in market integrity, capacity and technology. The market's continued smooth functioning in the face of substantial trading losses, volatility and volume confirms that we have taken a prudent course.

This year's market environment clearly presents greater challenges for us all. So the NASD is taking sound steps to meet them. These include right-sizing our staff to account for the separation of Nasdaq; realigning our budget earlier this year to reduce operating costs; and streamlining our business processes to achieve increased efficiencies.

We will continue to use funds to enhance our regulatory tools and services, and to sustain the revitalization of Amex. We also will maintain sufficient working capital to let us respond nimbly to the technology needs and global opportunities we face at this pivotal time in the NASD's evolution. Such steps are in keeping with my conviction that technology must be at the heart of the NASD's core competence and strategic vision. We are investing in regulatory technology without peer because we are committed to remaining the world's foremost provider of market integrity solutions.

Timely Changes and Timeless Values

The NASD has won a widespread reputation for trust and integrity. I salute all those whose expertise, hard work and commitment have earned us this standing.

But we live in an era when the markets do not tolerate standing still. The same efficiencies that have made America's private sector the global leader can also inform and improve the world's leading self-regulatory organization. This desire to hone our performance is what is leading us to adapt and apply what we have learned and developed to new areas, new uses and new users. You might call our vision "Back to the Future": returning to our regulatory roots, while also streamlining our methods and leveraging our assets in innovative ways.

Since taking the helm here last November, I have affirmed three important conclusions first formulated in my half decade as an active member of the NASD Board. One is that we are making the right changes – honing our techniques and technology to keep up with changes in the markets. The second is that we are evolving to the right extent – enough to succeed in a new competitive environment, but not so much that we are departing from our historic strengths or mission. The last is that we have the right people – the most knowledgeable and dedicated market integrity professionals on earth.

In light of all this, my view of the NASD's future matches that of the future of our industry. The challenges are many. But our finest days are yet to come.



*Robert R. Glauber, CEO and President
September 4, 2001*

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**THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
MANAGEMENT REPORT ON FINANCIAL OPERATIONS**

The year 2000 marked another record for the National Association of Securities Dealers, Inc. ("NASD") in terms of financial performance and, more importantly, in connection with the historic restructuring and recapitalization of The Nasdaq Stock Market, Inc. ("Nasdaq"). The financial results were largely driven by increases in the trading volumes of the securities markets. Consolidated revenues reached an all time high of \$1.555 billion, approximately \$310 million, or 25 percent, ahead of last year's total of \$1.245 billion. Income before the cumulative effect of a change in accounting principle increased by approximately 42 percent to \$219 million versus the prior year's net income of \$154 million. In April 2000, the NASD membership voted overwhelmingly to support a plan to broaden the ownership in Nasdaq

through the private placement by Nasdaq of new shares and by the NASD of shares and warrants to purchase Nasdaq common stock owned by the NASD. The principal goals of the restructuring included (i) strategically re-aligning the ownership of Nasdaq by enlisting a broad class of investor-owners, including Nasdaq market participants, issuers and members committed to Nasdaq's long-term success; (ii) permitting the NASD to focus more intently on its primary mission of being a membership-focused self-regulatory organization; (iii) streamlining corporate governance and minimizing potential regulatory conflicts of interest; and (iv) further strengthening the financial position of the NASD and Nasdaq. Phase I of the private placement successfully closed in June 2000, effectively placing nearly 20 percent

Summary of Proceeds (millions)

Phase I (June 2000):

Sale of Nasdaq shares
Sale of warrants on Nasdaq shares
Sale of newly issued Nasdaq shares

Phase II (January 2001):

Sale of Nasdaq shares
Sale of warrants on Nasdaq shares
Sale of newly issued Nasdaq shares

Nasdaq Share Purchase (May 2001):

Sale of convertible debentures
Sale of Nasdaq shares

Total Net Proceeds

	NASD Proceeds	Nasdaq Proceeds	Total Proceeds
	\$ 3.5	\$ -	\$ 3.5
	68.7	-	68.7
	-	253.3	253.3
	\$ 53.5	\$ -	\$ 53.5
	59.9	-	59.9
	-	63.7	63.7
	\$ -	\$ 240.0	\$ 240.0
	240.0	(240.0)	-
	\$ 425.6	\$ 317.0	\$ 742.6

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
MANAGEMENT REPORT ON FINANCIAL OPERATIONS (CONTINUED)

of Nasdaq's ownership (40 percent on a fully diluted basis) in the hands of over 2,800 new investors. Phase II closed in January 2001, further increasing the outside ownership in Nasdaq to nearly 26 percent (60 percent on a fully diluted basis).

Additionally, in May 2001, the NASD sold approximately 18.5 million shares of Nasdaq common stock to Nasdaq for \$13 per share for an aggregate purchase price of \$240 million. Nasdaq purchased the shares with net proceeds received from a sale of \$240 million of its convertible subordinated debentures ("Nasdaq Share Purchase"). As shown on the previous page, the two-phased offering and the Nasdaq

Share Purchase produced total net proceeds to NASD and Nasdaq of \$426 million and \$317 million, respectively.

The table below summarizes the changes in members' equity for the years 1999 and 2000, shows the impact of Phase I and, on a proforma basis, the impact of Phase II which occurred in January 2001, and the Nasdaq Share Purchase, which occurred in May 2001. The book value per Nasdaq share held by the NASD rose from \$3.52 to \$4.25 on a proforma basis after the closures of Phase II and the Nasdaq Share Purchase. Full exercise of all outstanding warrants could provide additional capital to the NASD up to \$625 million between 2002 and 2006. As part of its overall strategy,

NASD Members' Equity (dollars in thousands, except per share amounts)

	Year Ended 12/31/99	Year Ended 12/31/00	Phase II Additional Effect ⁴	Nasdaq Share Purchase Additional Effect ⁵	Year Ended 12/31/00 Proforma ⁶
NASD (excluding Nasdaq)					
Members' equity – beginning of year	\$ 186,096	\$ 255,781	\$ –	\$ –	\$ 255,781
Net income excluding gain on sale of stock	67,667	94,278	–	–	94,278
Gain on sale of Nasdaq shares	–	2,347	31,445	179,605	213,397
Accumulated other comprehensive income (loss)	2,018	(4,114)	–	–	(4,114)
Reinstatement of book value of Nasdaq shares sold by NASD	–	1,112	22,028	60,395	83,535
Members' equity – end of year	<u>\$ 255,781</u>	<u>\$ 349,404</u>	<u>\$ 53,473</u>	<u>\$ 240,000</u>	<u>\$ 642,877</u>

NASD Members' Equity (dollars in thousands, except per share amounts) (continued)

	Year Ended 12/31/99	Year Ended 12/31/00	Phase II Additional Effect ⁴	Nasdaq Share Purchase Additional Effect ⁵	Year Ended 12/31/00 Proforma ⁶
NASD's ownership interest in Nasdaq					
Nasdaq equity – beginning of year	\$ 266,141	\$ 352,012	\$ –	\$ –	\$ 352,012
Net income	86,149	23,306	–	–	23,306
Accumulated other comprehensive income (loss)	(278)	(3,634)	–	–	(3,634)
Proceeds from sale of newly issued shares	–	253,291	63,683	–	316,974
Treasury stock purchase from NASD	–	–	–	(240,000)	(240,000)
Adjustment to carrying amount of investment in Nasdaq Japan due to its private placement	–	7,784	–	–	7,784
Capital contributions – Nasdaq Europe	–	12,400	–	–	12,400
Total Nasdaq equity at 12/31	352,012	645,159	63,683	(240,000)	468,842
Claim of minority interest from sale of Nasdaq shares by NASD	–	(1,686) ²	(26,344)	41,291	13,261
Claim of minority interest from sale of newly issued shares by Nasdaq	–	(123,874) ²	(31,376)	–	(155,250)
NASD's share of Nasdaq's equity at 12/31	352,012	519,599	5,963	(198,709)	326,853
Total NASD members' equity at 12/31	\$ 607,793	\$ 869,003	\$ 59,436	\$ 41,291	969,730
Nasdaq common shares held by NASD	100,000,000 ¹	99,676,814	–	–	76,992,671
Book value per Nasdaq shares held by NASD ³	\$ 3.52	\$ 5.21	–	–	\$ 4.25
NASD ownership % in Nasdaq	100.0%	80.6%	–	–	69.8%
NASD ownership % assuming full dilution	100.0%	59.9%	–	–	27.6%

¹ — Gives effect to 49,999-for-one stock dividend on June 28, 2000.

² — Minority interests on the consolidated balance sheets include these amounts plus the minority interest in Nasdaq Europe.

³ — NASD's share of Nasdaq's equity at 12/31, divided by the number of Nasdaq common shares held by NASD.

⁴ — Reflects the Phase II sale of 5,028,797 Nasdaq shares by Nasdaq for \$63.7 million; and the sale of 4,222,295 Nasdaq shares by the NASD for \$53.5 million, resulting in a gain of \$31.4 million. Phase II sales of warrants increased liabilities by \$59.9 million, which is not reflected above.

⁵ — Reflects the NASD sale of 18,461,538 Nasdaq shares to Nasdaq for \$240.0 million. Nasdaq purchased the shares with proceeds received from a sale of its convertible debentures.

⁶ — Reflects the effect on members' equity of the Phase II transaction (1/18/01) and the Nasdaq Share Purchase (5/3/01) as if it occurred on 12/31/00.

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
MANAGEMENT REPORT ON FINANCIAL OPERATIONS (CONTINUED)

Nasdaq has applied to the Securities and Exchange Commission ("SEC") for registration as an exchange. At the time such registration is approved, the NASD will relinquish voting control of Nasdaq to the other investor owners. In addition, NASD intends to pursue efforts to further reduce its equity ownership in Nasdaq through possible private sales of Nasdaq stock, or, in the event Nasdaq proceeds with an initial public offering of shares, as part of such offering.

The NASD has earmarked \$100 million of the proceeds to date for the benefit of its subsidiaries, NASD Regulation and The American Stock Exchange ("Amex"), of which \$25 million has been invested in Amex as of December 31, 2000. The NASD has committed additional earmarked amounts to those entities from future proceeds. As a non-profit membership association, the NASD cannot distribute equity directly to the membership, although it can re-price its services. The NASD is committed to reducing its membership fees by an additional \$107 million through 2006 assuming a sufficient level of the warrants are exercised.

Turning back to the financial results for 2000, the growth in revenues was largely fueled by the increase in trading volumes for Nasdaq and Amex. Specifically, average daily share volume for Nasdaq totaled 1.77 billion shares per day, representing a 62 percent growth over 1999. Amex, following suit, trading a record 208 million options contracts, crossing the 200 million mark for the first time. Amex equity and options volume increased by 63 percent and 60 percent, respectively, over the prior year. Market information services revenue for Amex and Nasdaq combined increased by approximately \$77 million or 28 percent due to an increase in the population of professional, retail, institutional and

non-professional users, as well as a significant increase in the amount of non-professional quote inquiries.

Offsetting the above increases in revenue is a decrease in issuer services revenues of \$19 million, or 11 percent. The NASD historically recognized revenue for initial listing fees and listing of additional shares fees in the month the listing occurred or in the period the additional shares were issued, respectively. The SEC's Staff Accounting Bulletin 101 ("SAB 101"), effective in 2000, has resulted in a new interpretation of accounting principles, when applied to listing fees, relating to the timing of the recognition of such revenue. As a result, after discussions with the SEC, the NASD now recognizes revenue relating to these fees on a straight-line basis over the estimated service period. Prior to this change in methodology, the NASD reflected an increase in issuer services revenues for 2000 of \$23 million, or 13 percent, as a result of an increase in the average size of initial public offerings and additional share listings in 2000 over 1999. Therefore, the impact of this accounting change to 2000 issuer service revenues is a reduction of \$42 million, or 21 percent. Additionally, the NASD was required to recognize the cumulative effect at the beginning of the year of this change in accounting principle during 2000. This adjustment further reduced net income, net of taxes by \$105 million. Net income after this accounting change for 2000 is \$114 million, a \$40 million, or 26 percent reduction from 1999 net income of \$154 million.

With respect to regulatory operations, assessments based on members' business volumes grew by \$23 million or 23 percent, which is driven by the performance experienced within the securities industry in the prior year. Registration

and qualification fee revenues decreased slightly from prior year levels. Although the population of registered representatives grew by approximately 8 percent to accommodate the increase in industry activity, overall revenue decreased in this area due to a change in the rate structure. Regulatory transaction fees increased by over \$36 million or 54 percent in direct correlation to the increase in average daily share and trading volume. Additional areas of importance centered on the establishment of the professional development certification within the industry and the strengthening of arbitration and mediation functions.

In response to the growing importance of dispute resolution services to the marketplace, a subsidiary of NASD, Inc., NASD Dispute Resolution, Inc., was formed. Among its activities this year, NASD Dispute Resolution improved the quality of arbitration panels, saw an increase in the use of its successful Mediation Program and published discovery guidelines for use in NASD arbitration proceedings.

Additionally, the NASD Institute for Professional Development ("NIPD"), including the NASD Institute-Wharton Certificate Program, was launched to provide uniform, comprehensive academic programs for financial industry professionals and regulators.

In light of the financial benefits experienced due to the growth in market volume, the NASD made a concerted effort to reduce member costs and pass savings along to the industry and investors. Significant fee adjustments, volume discounts and rebates were enacted on transaction and market data fees, member assessments and CRDSM fees.

Operating expenses equaled \$1.238 billion or a 21 percent increase over the prior year. A continued focus was devoted to major system development and maintenance projects, Amex corporate systems development and integration, global initiatives and system environment costs to accommodate the growth in share volume. Capacity-related enhancements for Nasdaq now provide the capability to trade 6 billion shares a day, a ten-fold increase since 1997. On 47 different occasions, Nasdaq experienced trading days where volume exceeded two billion shares. Other important technology initiatives that were initiated or completed in 2000 included the migration of 10 regulatory filing systems to the Web, successful launch of pilots for INSITE and IARDTM, and the continued design of SuperMontageTM, a breakthrough trading system that offers a better way of displaying and accessing market quotes and orders. In addition to implementing new products, continued emphasis was placed on identifying opportunities to streamline, automate and enhance regulatory systems and processes, where possible, thus modernizing out-of-date applications to become more user friendly and efficient in nature.

The NASD continues to make progress towards the revitalization of Amex. In addition to adding more than 100 new equity listings, its exchange traded funds ("ETFs") business continues to be recognized as a global leader, while assets and volume nearly doubled for the sixth consecutive year. To further expand the ETF business, the Amex signed a watershed joint venture agreement with the Singapore Exchange and is expected to commence trading in the first half of 2001. Continued reinvestment in the business was evidenced by the recent initiation of a 7,000-square-foot

**THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
MANAGEMENT REPORT ON FINANCIAL OPERATIONS (CONTINUED)**

expansion of the trading floor, further highlighting the continued growth that the Amex has achieved.

Capital spending on property and equipment totaled a record \$267 million in 2000. Spending on technology and related facilities accounted for the largest portion, totaling \$138 million, as the NASD continued to respond to the rapid growth in Nasdaq market volumes and associated surveillance and regulatory systems. The NASD's newest facility, a 250,000 square foot complex, was formally opened in Rockville, Maryland, allowing consolidation of area operations into one facility providing estimated long-term occupancy savings of \$19 million to the organization. During 2000, approximately \$35 million was incurred to

complete the construction of this new facility. Furthermore, the NASD finalized a long-term lease of 200,000 square feet of office space for the New York operations. This lease included an incentive package from the City and State of New York that will provide projected savings of \$64 million over 20 years.

At year-end working capital totaled \$568 million, comprised of \$135 million and \$433 million for NASD (excluding Nasdaq) and Nasdaq, respectively. This substantial liquidity places both the NASD and Nasdaq in strong operating positions to respond to technology needs and global opportunities in the fast-changing environment of exchange markets.

**THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
MANAGEMENT REPORT ON FINANCIAL REPORTING RESPONSIBILITY**

Management is responsible for the preparation, integrity, and objectivity of the consolidated financial statements of the National Association of Securities Dealers, Inc. ("NASD"). This responsibility includes the selection of accounting procedures and practices, which are in accordance with generally accepted accounting principles. The consolidated financial statements have been prepared in conformity with these procedures and practices applied on a consistent basis. These consolidated financial statements reflect informed judgments and estimates, that management believes to be reasonable, in the determination of certain data used in the accounting and reporting process.

The NASD maintains an effective system of internal accounting controls that is periodically modified and improved to correspond with changes in the NASD's operations. This system of internal controls is designed to provide assurance that the assets of the NASD are safeguarded against loss from unauthorized use or disposition and that the books and records, from which the consolidated financial statements were prepared, properly reflect the financial transactions of the NASD. Important elements of the internal control system include capital and operating budgets, which are subjected to continuous review and reporting throughout the year; an organizational structure providing segregation of responsibilities; established policies and procedures; careful selection and training of qualified personnel; and an internal audit program developed and carried out by the NASD's Internal Review Department. The Internal Review Department is directly responsible to the Audit Committee of the Board of Governors of the NASD. It is management's opinion that the system of internal control as of December 31, 2000, is effective in providing reasonable assurance that the consolidated financial statements are free of material misstatement.

The Board of Governors of the NASD establishes charters for its Audit and Finance Committees, as applicable. The Audit Committee provides assistance to the Board of Governors in fulfilling its oversight responsibility relating to the NASD's financial statements and the financial reporting process, the systems of internal accounting and financial controls, the internal audit function, and the annual independent audit of the NASD's financial statements. The Audit Committee consists of four Governors, each of whom is independent of management and the NASD.

The Finance Committee oversees the financial operations and condition of the NASD through review and discussion of current financial results; reviews annual operating and capital budgets and material modifications thereto; and reviews all other financial matters related to the operation and financial position of the NASD. The Finance Committee, with the exception of the CEO of the NASD, consists of non-employee Governors, at least one-half of whom are non-industry members.

The NASD's independent auditors, Ernst & Young, have conducted an audit in accordance with generally accepted auditing standards of the consolidated financial statements of NASD for the years ended December 31, 2000 and 1999. Representatives of Ernst & Young have met with NASD management and with members of the Audit Committee of the Board of Governors with and without management present to discuss the results of their audits and other accounting, auditing and financial matters.

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
CONSOLIDATED BALANCE SHEETS (DOLLARS IN THOUSANDS)

	December 31,	
	2000	1999
Assets		
Current assets:		
Cash and cash equivalents	\$ 603,896	\$ 161,040
Investments:		
Available-for-sale, at fair value	522,288	475,757
Held-to-maturity, at amortized cost	21,968	10,697
Receivables, net	280,907	151,544
Deferred tax assets	31,193	5,213
Other current assets	21,502	23,291
Total current assets	<u>1,481,754</u>	<u>827,542</u>
Investments:		
Held-to-maturity, at amortized cost	6,612	17,720
Property and equipment:		
Land, buildings and improvements	202,063	126,040
Data processing equipment and software	571,550	371,825
Furniture, equipment and leasehold improvements	294,543	227,268
	<u>1,068,156</u>	<u>725,133</u>
Less accumulated depreciation and amortization	(428,082)	(329,907)
Total property and equipment, net	<u>640,074</u>	<u>395,226</u>
Non-current deferred tax assets	66,591	6,652
Investments in warrants, at cost	—	33,480
Other assets	82,502	30,022
Total assets	<u><u>\$ 2,277,533</u></u>	<u><u>\$ 1,310,642</u></u>

See accompanying notes to consolidated financial statements.

	December 31,	
	2000	1999
Liabilities and members' equity		
Current liabilities:		
Accounts payable and accrued expenses	\$ 262,874	\$ 155,018
Net SEC fees	189,285	113,578
Accrued personnel costs	134,979	118,149
Deferred revenue	113,805	45,023
Short-term borrowings	50,000	35,000
Deposits and renewals	39,141	29,399
Due to banks	35,533	20,484
Other accrued liabilities	66,107	33,916
Total current liabilities	891,724	550,567
Accrued pension costs	28,765	20,424
Long-term debt	25,000	25,000
Accrued other postretirement benefit costs	21,010	21,910
Non-current deferred tax liabilities	44,817	26,317
Deferred revenue	149,310	-
Deferred revenue, investments in warrants, at cost	-	33,480
Warrants to purchase Nasdaq stock from NASD	68,665	-
Other liabilities	38,135	25,151
Total liabilities	1,267,426	702,849
Minority interests	141,104	-
Members' equity	868,952	600,362
Unrealized gains on available for sale investments, net of tax and minority interests	1,834	7,431
Foreign currency translation, net of minority interests	(1,783)	-
Total members' equity	869,003	607,793
Total liabilities and members' equity	\$ 2,277,553	\$ 1,310,642

See accompanying notes to consolidated financial statements.

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
CONSOLIDATED STATEMENTS OF INCOME (DOLLARS IN THOUSANDS)

	Years ended December 31,	
	2000	1999
Revenues		
Transaction services	\$ 519,045	\$ 372,975
Market information	353,885	276,478
Issuer services	158,113	177,219
Member assessments	123,680	100,640
Registration and qualification fees	120,718	123,525
Regulatory service fees and fines	113,865	93,536
Interest and other	105,502	50,592
Arbitration fees	36,405	30,767
Corporate financing fees	23,383	18,813
Total revenues	<u>1,554,596</u>	<u>1,244,545</u>
Expenses		
Compensation and benefits	410,399	372,243
Professional and contract services	324,968	236,926
Computer operations and data communications	173,198	131,906
Depreciation and amortization	112,787	78,351
Occupancy	47,504	38,675
Marketing and advertising	45,855	69,602
Travel, meetings and training	30,129	29,797
Publications, supplies and postage	29,292	27,390
Other	63,383	39,428
Total operating expenses	<u>1,237,515</u>	<u>1,024,318</u>
Net operating income	317,081	220,227
Provision for income taxes	(95,077)	(66,411)
Gain from Nasdaq shares sold by NASD	2,347	-
Minority interests in earnings	(5,466)	-
Income before cumulative effect of change in accounting principle	<u>\$ 218,885</u>	<u>\$ 153,816</u>
Cumulative effect of change in accounting principle, net of taxes	<u>(105,292)</u>	<u>-</u>
Net income	<u>\$ 113,593</u>	<u>\$ 153,816</u>
Pro forma net income assuming the accounting change is applied retroactively	<u>\$ 218,885</u>	<u>\$ 133,993</u>

See accompanying notes to consolidated financial statements.

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN MEMBERS' EQUITY (DOLLARS IN THOUSANDS)

	Members' Equity	Accumulated Other Comprehensive Income (Loss)	Total
Balance, January 1, 1999	\$ 446,546	\$ 5,691	\$ 452,237
Net income	153,816	-	153,816
Unrealized gains on available-for-sale investments, net of tax of (\$149)	-	1,740	1,740
Comprehensive income			155,556
Balance, December 31, 1999	600,362	7,431	607,793
Net income	113,593		113,593
Unrealized loss on available-for-sale investments, net of tax of (\$765), net of minority interests of \$62	-	(5,597)	(5,597)
Foreign currency translation, net of minority interests of (\$1,322)	-	(1,783)	(1,783)
Comprehensive income			106,213
Increase in equity attributable to the issuance of Nasdaq stock	136,323	-	136,323
Adjustment to carrying amount of investment in Nasdaq Japan due to its private placement, net of minority interests of \$1,510	6,274	-	6,274
Increase in equity attributable to the formation of Nasdaq Europe	12,400	-	12,400
Balance, December 31, 2000	<u>\$ 868,952</u>	<u>\$ 51</u>	<u>\$ 869,003</u>

See accompanying notes to consolidated financial statements.

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (DOLLARS IN THOUSANDS)

	Years ended December 31,	
	2000	1999
Cash flow from operating activities		
Cash received from customers	\$ 1,390,155	\$ 1,084,068
Cash paid to suppliers and employees	(939,822)	(834,039)
Income taxes paid	(101,971)	(49,992)
Interest received, net	72,692	47,956
Other	4,811	(7,855)
Cash provided by operating activities	425,865	240,138
Cash flow from investing activities		
Proceeds from redemptions of available-for-sale investments	732,300	535,684
Purchases of available-for-sale investments	(786,731)	(632,592)
Proceeds from maturities of held-to-maturity investments	10,810	30,743
Purchases of held-to-maturity investments	(10,973)	(30,990)
Net Phase I proceeds from Nasdaq shares sold by the NASD	3,459	-
Net Phase I proceeds from warrants sold by the NASD	68,665	-
Acquisition, net of cash acquired	(16,979)	-
Purchases of property and equipment, net	(357,608)	(226,442)
Cash used in investing activities	(357,057)	(323,597)
Cash flow from financing activities		
Increase in due to banks	15,049	11,641
Net SEC fees	75,707	51,274
Net Phase I proceeds from newly issued Nasdaq stock	253,292	-
Contributions from minority shareholders in Nasdaq Europe	30,000	-
Member equity program payment	(15,000)	-
Proceeds from issuance of debt	15,000	35,000
Cash provided by financing activities	374,048	97,915
Increase in cash and cash equivalents	442,856	14,456
Cash and cash equivalents at beginning of year	161,040	146,584
Cash and cash equivalents at end of year	\$ 603,896	\$ 161,040

	Years ended December 31,	
	2000	1999
Reconciliation of net income to net cash provided by operating activities		
Net income	\$ 113,593	\$ 153,816
Non-cash items included in net income:		
Cumulative effect of change in accounting principle, net of taxes	105,292	-
Depreciation and amortization	112,787	78,351
Gain from Nasdaq shares sold by NASD	(2,347)	-
Stock-based compensation	3,788	-
Minority interests in earnings	5,466	-
Net change in:		
Increase in receivables, net	(128,991)	(52,349)
Decrease (increase) in other current assets	1,789	(1,077)
Increase in deferred taxes	(14,527)	(3,650)
Increase in other assets	(13,935)	(13,438)
Increase in accounts payable and accrued expenses	107,830	32,208
Increase in accrued personnel costs	16,747	27,673
Increase in deferred revenue	41,408	10,797
Increase (decrease) in other accrued liabilities	28,298	(1,676)
(Decrease) increase in accrued post-retirement costs	(900)	1,607
Increase in accrued pension costs	8,341	358
Increase (decrease) in deposits and renewals	9,742	(2,778)
Increase (decrease) in other liabilities	12,984	(3,621)
Increase in non-current deferred tax liabilities	18,500	13,917
Cash provided by operating activities	\$ 425,865	\$ 240,138

See accompanying notes to consolidated financial statements.

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (DOLLARS IN TABLES IN THOUSANDS)

1. Organization and Nature of Operations

The National Association of Securities Dealers Inc. ("NASD") 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.; collectively referred to as the Company.

At a special meeting of the 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 Common Stock, and (2) Common Stock and Warrants to purchase shares of Common Stock owned by the NASD (the "Restructuring"), to NASD members, Nasdaq market participants, Nasdaq issuers, institutional investors and other strategic partners. The Restructuring is 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) the NASD separated Amex from The Nasdaq-Amex Market GroupSM ("Market Group"), a holding company which was a subsidiary of the 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 the NASD); (4) Nasdaq authorized the issuance of an additional 30.9 million in new shares to be offered for sale by Nasdaq; and (5) the NASD formed a new subsidiary, New NASD Holding, Inc. to hold the NASD's interest in Amex.

Phase I of the Restructuring closed on June 28, 2000 yielding net proceeds to the NASD and Nasdaq of approximately \$72.1 million and \$253.3 million, respectively. As of December 31, 2000, the NASD owned approximately 81 percent of Nasdaq. During Phase I of the Restructuring, the NASD sold Warrants to purchase shares of the common stock of Nasdaq, that if fully exercised, would decrease the NASD's ownership to approximately 60 percent. Phase II of the Restructuring closed on January 18, 2001 (see Note 14).

Phase I of the Restructuring consisted of three separate transactions: (1) the NASD sold 323,196 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) the NASD sold 6,415,049 warrants to purchase an aggregate of 25,660,196 NASD-owned common shares of Nasdaq at \$11.00 per warrant generating net proceeds to the NASD of \$68.7 million; and (3) Nasdaq sold 23,663,746 newly issued common shares at \$11.00 per share generating net proceeds to Nasdaq of \$253.3 million. The NASD has received a ruling from the Internal Revenue Service stating that the sale of Nasdaq shares and warrants will not result in taxable income to the NASD.

1. Organization and Nature of Operations (continued)

Each Warrant sold by the NASD entitles the holder to purchase four shares of Nasdaq Common Stock owned and held by the NASD for prices ranging from \$13.00 to \$16.00 per share. Each Warrant is exercisable for twelve months in each of the four annual tranches, with one share of Common Stock available for purchase in each tranche. The first annual tranche commences on June 28, 2002.

Until Nasdaq's registration as an exchange is approved by the SEC and becomes effective ("Exchange Registration"), the shares of Common Stock underlying unexercised and unexpired Warrant tranches, as well as the shares of Common Stock purchased through the exercise of Warrants, will be voted by a voting trustee at the direction of the NASD. Upon Exchange Registration, the Warrant holders will have the right to direct the voting trustee as to the voting of the shares of Common Stock underlying unexercised and unexpired Warrant tranches. Additionally, the NASD has determined, commencing upon Exchange Registration, to vote its shares of Common Stock (other than shares underlying then outstanding Warrants) in the same proportion as the other common stockholders of Nasdaq. As a result of these conditions, the NASD has a controlling interest in Nasdaq until Exchange Registration is effective.

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. Amex uses a specialist system to operate a floor-based exchange. The majority of Nasdaq and Amex business is

transacted with listed companies, market data vendors and firms in the broker/dealer industry within the U.S.

NASD oversees the activities of the U.S. broker/dealer profession and regulates Nasdaq and the over-the-counter securities markets. NASDR carries out the 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. On July 3, 2000, NASDR spun off its arbitration and mediation services into a newly created subsidiary, NASD DR. NASD DR provides arbitration and mediation services to assist in the resolution of disputes between investors and securities firms and others. New NASD Holding, Inc. holds the Company's interest in Amex.

2. Significant Transactions

In February 2000, the NASD formed a joint venture, Nasdaq Europe Planning Company Limited ("Nasdaq Europe"), with SOFTBANK, Vivendi, and Epartners, whereby each partner contributed \$10.0 million in cash. The NASD contributed \$10.0 million in cash, licensing of its brand, technology expertise, and management leadership in exchange for a 56 percent ownership interest in this venture. As a part of the Restructuring, the NASD's ownership interest in Nasdaq Europe was transferred to Nasdaq Global Holdings ("Nasdaq Global"). Nasdaq Global, which is incorporated in Switzerland, is the holding company for Nasdaq's investments in Nasdaq Europe and Nasdaq Japan, Inc. ("Nasdaq Japan").

In 1999, the NASD contributed approximately \$2.6 million for its initial 50 percent interest in Nasdaq Japan. After

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (DOLLARS IN TABLES IN THOUSANDS)

2. Significant Transactions (continued)

granting a restricted stock award of four percent of its shares, the NASD transferred its remaining 46.0 percent interest to Nasdaq Global. Nasdaq Global accounts for its investment in Nasdaq Japan under the equity method of accounting, and had reduced the carrying value of its investment in Nasdaq Japan to zero as a result of recording its share of the operating losses incurred by Nasdaq Japan.

In October 2000, Nasdaq Japan sold an approximately 15.0 percent stake for approximately \$48 million to a group of 13 major Japanese, U.S. and European brokerages, thereby reducing Nasdaq Global's interest from approximately 46.0 percent to approximately 39.2 percent. As a result of the private placement, Nasdaq Global adjusted the carrying value of its investment in Nasdaq Japan, through equity, to reflect its adjusted share of the book value of Nasdaq Japan. As of December 31, 2000, Nasdaq's investment in Nasdaq Japan is approximately \$8.0 million.

On March 7, 2000, Nasdaq acquired Financial Systemware, Inc. (now known as Nasdaq Tools, Inc. ("Nasdaq Tools")), a company which develops and markets a set of software utilities that can be loaded on a Nasdaq Workstation II® terminal to enhance the features and functionalities of the Nasdaq Workstation II software. This acquisition has been accounted for using the purchase method of accounting, and accordingly, assets acquired and liabilities assumed have been recorded at their estimated fair values at the date of acquisition. The results of operations of Nasdaq Tools are included in the consolidated statements of income and members' equity from the acquisition date. Periods prior to the acquisition date are not included in the consolidated statements of income and members' equity.

Upon closing of the transaction, Nasdaq acquired 100 percent of Financial Systemware's issued and outstanding stock for \$7.3 million. Goodwill of \$6.5 million was recorded as a result of the acquisition and is being amortized on a straight-line basis over five years. Additionally, the Nasdaq Tools principals, the sellers, will collectively be paid \$25.0 million. Of this amount, \$10.0 million was paid upon closing and is being recognized as expense on a straight-line basis over five years. Five cash payments of \$3.0 million each will be paid over the five years following closing, contingent upon the continued employment and development efforts of the Nasdaq Tools principals. These five cash payments will be expensed as incurred. The unamortized goodwill and other intangible assets related to the acquisition of Nasdaq Tools are \$5.4 million and \$8.3 million, respectively, as of December 31, 2000 and are included in other assets in the consolidated balance sheets.

3. Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of the NASD and its majority-owned subsidiaries. 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.

3. Summary of Significant Accounting Policies (continued)

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. Such investments included in cash and cash equivalents in the consolidated balance sheets were \$547.8 million and \$143.7 million at December 31, 2000 and 1999, respectively.

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 market 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 or available-for-sale is adjusted for amortization of premiums and accretion of discounts. Realized gains and losses on sales of securities are included in earnings using the specific identification method.

A decline in the market value of any available-for-sale or held-to-maturity security below cost, that is deemed to be other than temporary, is charged to earnings and a new cost basis for the security is established.

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 uncollectible 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 \$16.2 million and \$11.1 million at December 31, 2000 and 1999, respectively.

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 market value or the present value of future lease payments. Depreciation and amortization are provided on the straight-line method. Estimated useful lives generally range from 10 years to 40 years for buildings and improvements, 2 years to 5 years for data processing equipment and software, and 5 years to 10 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.

Impairment 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 is 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.

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (DOLLARS IN TABLES IN THOUSANDS)

3. Summary of Significant Accounting Policies
(continued)

If a write-down is required, the Company would prepare a discounted cash flow analysis to determine the amount of the write-down.

Investments in Affiliates

The Company carries its various investments in affiliates at cost and under the equity method of accounting depending upon its ability to influence the operation of the affiliate. Investments in affiliates are included in other assets in the consolidated balance sheets and amount to approximately \$26.0 million and \$12.3 million as of December 31, 2000 and 1999, respectively.

Net SEC Fees

NASD and Amex collect a fee based on a percentage of the total dollar value of securities sold in the NASD 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 charges these fees monthly to 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 mainly cash received and billed receivables, which are unearned until services are provided. Included in deferred revenue are unamortized Initial Listing Fees and Listing of Additional Shares Fees ("LAS"). Initial

Listing Fees are recognized over periods ranging from six to seven 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 \$21.7 million and \$18.1 million as of December 31, 2000 and 1999, respectively. CRD renewals included in deposits and renewals in the consolidated balance sheets totaled \$14.4 million and \$9.1 million as of December 31, 2000 and 1999, respectively.

Warrants to Purchase Nasdaq Stock from NASD

The NASD accounts for the warrants to purchase Nasdaq stock at the amount of the net warrant proceeds received.

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. Transaction service, regulatory service, fees, and registration and qualification fees are variable based on service volumes and are recognized as transactions occur. Arbitration fees are recognized as cases are filed and sessions are held. Issuer annual listing service revenues are recognized ratably over the following 12-month period. For 1999, issuer initial listing fees were recognized in the

3. Summary of Significant Accounting Policies (continued)

month the listings occurred and LAS fees were recognized in the period the incremental shares were issued. Effective January 1, 2000, the accounting for these fees changed as described in Note 4.

Advertising Costs

The Company expenses advertising costs, which include media advertising and production cost, in the periods in which the costs are incurred. Media advertising and production costs included as marketing and advertising in the consolidated statements of income totaled \$35.8 million and \$51.4 million for 2000 and 1999, 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 five years. All other purchased software is charged to expense as incurred.

The Company adopted SOP 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" effective January 1, 1999. The provisions of this SOP require certain costs incurred in connection with developing or obtaining internal use software to be capitalized. Prior to January 1, 1999, the Company expensed such costs as incurred. Unamortized capitalized software development costs of \$104.8 million and \$36.6 million as of December 31, 2000 and 1999, respectively, are carried in data processing equipment and software in the consolidated balance sheets.

Amortization of costs capitalized under SOP 98-1 totaled \$5.6 million and \$1.1 million for 2000 and 1999, respectively, and are included in depreciation and amortization in the consolidated statements of income.

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 reverse.

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.

Minority Interests

Minority interests in the consolidated balance sheets represent the minority owners' share of equity 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 certain consolidated subsidiaries.

3. Summary of Significant Accounting Policies (continued)

Classifications

Certain amounts for the prior year have been reclassified to conform with the 2000 presentation.

Recent Accounting Pronouncements

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133 provides a comprehensive and consistent standard for the recognition and measurement of derivatives and hedging activities. In June 1999, FASB issued SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities-Deferral of the Effective Date of FASB Statement No. 133" which defers the date of adoption of SFAS No. 133 such that it is effective for fiscal years beginning after June 15, 2000. Management expects that the adoption of SFAS No. 133 will have an impact on the Company's operating results at such time that Nasdaq's equity securities become exchange traded and certain restrictions on transferability of the warrants lapse or are rescinded. At that time, any unexercised warrants would be considered derivatives which require fair value accounting under SFAS No. 133.

4. Change in Accounting Principle

On August 17, 2001, Nasdaq concluded discussions with the SEC with respect to the implementation in its financial statements of Staff Accounting Bulletin 101, "Revenue

Recognition in Financial Statements" ("SAB 101"), which became effective for SEC reporting companies in the fourth quarter of 2000. Nasdaq became a SEC public reporting company on June 29, 2001, the effective date of its Registration Statement on Form 10. As a result of Nasdaq's discussions with the SEC, Nasdaq and Amex have changed their method of accounting for revenue recognition for certain components of issuer services revenues. In accordance and consistent with generally accepted accounting principles, as SAB 101 was adopted effective the fourth quarter of 2000, the change in accounting principle has been applied as of January 1, 2000.

In accordance with applicable accounting guidance prior to SAB 101, the Company recognized revenue for issuer initial listing fees and LAS fees in the month the listing occurred or in the period additional shares were issued, respectively. The Company now recognizes revenue related to initial listing fees and LAS fees on a straight-line basis over estimated service periods. Estimated service periods for initial listing fees range from six to seven 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. This cumulative effect of a change in accounting principle decreased net income in the year ended December 31, 2000 by \$105.3 million to \$113.6 million. The adjustment to 2000 net income for the cumulative change to prior year's results consists of the following:

4. Change in Accounting Principle (continued)

Deferred initial fees	\$ 113,095
Deferred LAS fees	63,589
Total deferred fees	<u>176,684</u>
Deferred income tax benefit	(71,392)
Cumulative effect of a change in accounting principle	<u>\$ 105,292</u>

For the year ended December 31, 2000, Nasdaq and Amex recognized an aggregate of \$57.3 million in revenue that was included in the cumulative effect adjustment as of January 1, 2000. This revenue contributed \$34.2 million (after income taxes of \$23.1 million) to net income for the year ended December 31, 2000.

The change in accounting principle affects the primary financial statements and income tax and business segment information disclosures in Notes 8 and 13, respectively.

Following is a summary of amounts included in the Company's current and non-current deferred revenue as of December 31, 2000 relating to issuer service fees, and the years over which those amounts will be recognized:

	Initial	LAS	Total
2001	\$ 36,020	\$ 33,546	\$ 69,566
2002	31,227	25,001	56,228
2003	26,587	17,617	44,204
2004	21,860	6,144	28,004
2005 and thereafter	20,874	-	20,874
Total	<u>\$ 136,568</u>	<u>\$ 82,308</u>	<u>\$ 218,876</u>

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (DOLLARS IN TABLES IN THOUSANDS)

4. Change in Accounting Principle (continued)

Following is a summary of activity in the Company's current and non-current deferred revenue for the year ended December 31, 2000 relating to issuer service fees. The additions reflect the issuer services fees charged during the year while the amortization reflects the issuer services fee revenues recognized during the year based on the accounting methodology described above.

	Initial	LAS	Total
Balance as of January 1, 2000	\$ 113,095	\$ 63,589	\$ 176,684
Additions	58,560	53,774	112,334
Amortization	(35,087)	(35,055)	(70,142)
Balance as of December 31, 2000	<u>\$ 136,568</u>	<u>\$ 82,308</u>	<u>\$ 218,876</u>

5. Investments

Investments consist of U.S. Treasury securities, obligations of U.S. Government sponsored enterprises, municipal bonds, 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, 2000:

	Amortized	Gross Unrealized		Fair Value
	Cost	Gain	Loss	
Due in one year or less	\$ 225,506	\$ 242	\$ (5)	\$ 225,743
Due after one year through five years	233,096	777	(2,527)	231,346
Equity securities	62,059	5,789	(2,649)	65,199
	<u>\$ 520,661</u>	<u>\$ 6,808</u>	<u>\$ (5,181)</u>	<u>\$ 522,288</u>

Following is a summary of investments classified as held-to-maturity which are carried at amortized cost as of December 31, 2000:

	Amortized	Gross Unrealized		Fair Value
	Cost	Gain	Loss	
Due in one year or less	\$ 21,968	\$ 20	\$ (32)	\$ 21,956
Due after one year through five years	6,612	26	-	6,638
	<u>\$ 28,580</u>	<u>\$ 46</u>	<u>\$ (32)</u>	<u>\$ 28,594</u>

5. Investments (continued)

Following is a summary of investments classified as available-for-sale which are carried at fair value as of December 31, 1999:

	Amortized	Gross Unrealized		Fair Value
	Cost	Gain	Loss	
Due in one year or less	\$ 240,719	\$ 117	\$ (3,049)	\$ 237,787
Due after one year through five years	168,671	472	(3,088)	166,055
Equity securities	57,997	14,916	(998)	71,915
	<u>\$ 467,387</u>	<u>\$ 15,505</u>	<u>\$ (7,135)</u>	<u>\$ 475,757</u>

Following is a summary of investments classified as held-to-maturity which are carried at amortized cost as of December 31, 1999:

	Amortized	Gross Unrealized		Fair Value
	Cost	Gain	Loss	
Due in one year or less	\$ 10,697	\$ 7	\$ (178)	\$ 10,526
Due after one year through five years	17,720	-	(439)	17,281
	<u>\$ 28,417</u>	<u>\$ 7</u>	<u>\$ (617)</u>	<u>\$ 27,807</u>

As of December 31, 2000 and 1999, investments classified as held-to-maturity with a carrying amount of approximately \$28.0 million were pledged as collateral under the \$25.0 million note payable.

6. Fair Value of Financial Instruments

The Company considers cash and cash equivalents, accounts receivable, investments, accounts payable and accrued expenses, due to banks, and short and long-term borrowings to be its financial instruments. The carrying amounts reported in the balance sheets for cash and cash equivalents, accounts receivable, investments, accounts payable and accrued expenses, due to banks, and short-term bor-

rowings equal or closely approximate their fair values. 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, 2000 and 1999 approximates its carrying amount.

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (DOLLARS IN TABLES IN THOUSANDS)

7. Short and Long-Term Borrowings

In May 1997, Nasdaq entered into a \$25.0 million note payable (the "Note") with a U.S. 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 at a rate of 7.41 percent through May 2007. After May 2007, Nasdaq will incur interest equal to the Lender's cost of funds rate, as defined in the agreement, plus 0.5 percent. Interest expensed and paid under the Note totaled approximately \$1.9 million for each of the years ended December 31, 2000 and 1999.

In September 1999, the NASD entered into an unsecured line of credit agreement (the "Agreement") with the Lender. Under the Agreement, the NASD has the option to borrow up to \$50.0 million at LIBOR plus 0.3 percent (7.08 percent and 6.77 percent as of December 31, 2000 and 1999, respectively). Proceeds received related to borrowings under the Agreement were used to fund operating costs. As of December 31, 2000 and 1999, the NASD had \$50.0 and \$35.0 million, respectively, in outstanding borrowings under the agreement. Interest capitalized under the Agreement totaled \$2.1 million and \$0.3 million for 2000 and 1999, respectively. Interest expensed under the agreement in 2000 was \$1.5 million.

8. Income Taxes

The income tax provision includes the following amounts:

	Years ended December 31,	
	2000	1999
Current income taxes:		
Federal	\$ 77,700	\$ 42,912
State	14,782	10,549
Total current income taxes	<u>92,482</u>	<u>53,461</u>
Deferred income taxes:		
Federal	(55,065)	10,599
State	(13,732)	2,351
Total deferred income taxes	<u>(68,797)</u>	<u>12,950</u>
Provision for income taxes before cumulative effect of change in accounting principle	23,685	66,411
Deferred tax benefit attributable to cumulative effect of change in accounting principle	71,392	-
Total provision for income taxes	<u>\$ 95,077</u>	<u>\$ 66,411</u>

8. Income Taxes (continued)

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,	
	2000	1999
Federal	35.0%	35.0%
State	3.8	5.7
Other, net	0.6	0.2
Foreign losses without US benefit	2.8	-
Effective rate	<u>42.2%</u>	<u>40.9%</u>

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

	December 31,	
	2000	1999
Deferred tax assets:		
Deferred fees	\$ 82,600	\$ 2,233
Compensation and benefits	1,592	179
Bad debts	5,139	2,801
Other	4,293	6,652
Net operating losses	4,160	-
Total deferred tax assets	<u>97,784</u>	<u>11,865</u>
Deferred tax liabilities:		
Depreciation	(12,492)	(9,966)
Software development costs	(19,624)	(5,184)
Other	(12,701)	(11,167)
Total deferred tax liabilities	<u>(44,817)</u>	<u>(26,317)</u>
Net deferred tax assets (liabilities)	<u>\$ 52,967</u>	<u>\$ (14,452)</u>

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (DOLLARS IN TABLES IN THOUSANDS)

8. Income Taxes (continued)

Due to Nasdaq's foreign operations, Nasdaq has approximately \$5.0 million of foreign deferred tax assets, primarily net operating losses, the majority of which expire in seven years. These in-country deferred tax assets have been fully reserved by an offsetting valuation allowance as it is "more likely than not" that these deferred tax assets will not be realized. Deferred tax asset balances disclosed in the consolidated balance sheets and table above are shown net of the valuation allowance. In addition, New NASD Holding, Inc. has approximately \$9.2 million of net operating loss carry-forwards which expire in 20 years.

9. Employee Benefits

The Company provides defined benefit pension and postretirement benefit plans to certain employees. The NASD maintains a noncontributory, defined-benefit pension plan,

along with other arrangements, for the benefit of eligible employees of its subsidiaries other than Amex. The benefits are primarily based on years of service and the employees' average salary during the highest 60 consecutive months of employment. Amex maintains a contributory, defined-benefit pension plan for the benefit of eligible Amex employees. The benefits are primarily based on years of service and compensation levels. The plan assets consist primarily of fixed income and equity securities.

Amex also maintains postretirement benefit plans that provide medical and life insurance benefits for Amex retirees and eligible dependents. Amex employees become eligible for these benefits if they meet minimum age and service requirements and are eligible for retirement benefits. On January 1, 2001, the Amex plans were merged into the NASD's plan, and effective as of the merging of the plans, Amex employees receive the same future benefits as NASD employees.

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

	Pension Benefits		Other Postretirement Benefits	
	2000	1999	2000	1999
Change in benefit obligation				
Benefit obligation at beginning of year	\$ 164,114	\$ 162,031	\$ 20,655	\$ 20,303
Service cost	13,779	12,323	338	645
Interest cost	13,051	11,063	1,331	1,426
Amendments	1,864	9	(4,879)	-
Actuarial losses	9,424	13,785	250	(1,255)
Benefits paid	(11,151)	(12,128)	(538)	(1,059)
Curtailment / settlement (gain) loss	-	(4,904)	-	595
Loss (gain) due to change in discount rate	10,602	(18,065)	-	-
Benefit obligation at end of year	<u>\$ 201,683</u>	<u>\$ 164,114</u>	<u>\$ 17,157</u>	<u>\$ 20,655</u>

9. Employee Benefits (continued)

	Pension Benefits		Other Postretirement Benefits	
	2000	1999	2000	1999
Change in plan assets				
Fair value of plan assets at beginning of year	\$ 176,509	\$ 165,172	\$ -	\$ -
Actual return on plan assets	6,822	15,001	-	-
Company contributions	8,053	8,260	-	-
Participant contributions	219	204	-	-
Benefits paid	(11,151)	(12,128)	-	-
Fair value of plan assets at end of year	<u>\$ 180,452</u>	<u>\$ 176,509</u>	<u>\$ -</u>	<u>\$ -</u>
Funded status of the plan (underfunded)	(21,231)	12,395	(17,157)	(20,655)
Unrecognized net actuarial loss (gain)	23,447	(3,983)	(969)	(1,255)
Unrecognized prior service cost	2,706	2,887	(2,884)	-
Unrecognized transition obligation / (asset)	(1,500)	(1,725)	-	-
Prepaid (accrued) benefit cost	<u>\$ 3,422</u>	<u>\$ 9,574</u>	<u>\$ (21,010)</u>	<u>\$ (21,910)</u>

The accrued pension liability as of December 31, 2000 and 1999 is \$36.5 million and \$27.6 million, respectively. Of these amounts, \$28.8 million and \$20.4 million, respectively, are included as accrued pension costs in the consolidated balance sheets as of December 31, 2000 and 1999, respectively. The remaining amounts of \$7.7 million and \$7.2 million, respectively, are included in accrued personnel costs in the consolidated balance sheets at December 31, 2000 and 1999.

For all pension benefit plans with a projected benefit obligation in excess of plan assets as of December 31, 2000 and 1999, the aggregate projected benefit obligation totaled \$147.5 million and \$114.6 million, respectively. Plan assets for those plans totaled \$100.8 million and \$93.5 million, respectively, as of December 31, 2000 and 1999.

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (DOLLARS IN TABLES IN THOUSANDS)

9. Employee Benefits (continued)

	Pension Benefits		Other Postretirement Benefits	
	2000	1999	2000	1999
Weighted-average assumptions as of December 31				
Discount rate	7.5%	8.0%	7.5%	8.0%
Expected return on plan assets	9.0	9.0	-	-
Rate of increase (compensation or health care cost)	5.3	5.1	5.0	5.5

	Pension Benefits		Other Postretirement Benefits	
	2000	1999	2000	1999
Components of net periodic benefit cost				
Service cost	\$ 13,779	\$ 12,323	\$ 338	\$ 645
Interest cost	13,051	11,063	1,331	1,426
Expected return on plan assets	(15,896)	(13,823)	-	-
Amortization of unrecognized transition asset	(225)	(225)	-	-
Recognized net actuarial losses (gains)	179	165	(36)	-
Prior service cost (income) recognized	2,021	587	(189)	-
Curtailment/settlement loss (gain) recognized	1,296	(4,909)	(1,806)	595
Benefit cost (income)	<u>\$ 14,205</u>	<u>\$ 5,181</u>	<u>\$ (362)</u>	<u>\$ 2,666</u>

Curtailment gains in pension benefits in 1999 relate primarily to the transfer of employees to a third party under the Company's technology outsourcing agreement and to employee consolidation related to the acquisition of Amex.

The assumptions for the annual increase in the composite health care cost trend rate are 8.0 percent for 2000 and

6.2 percent for 1999. The health care cost trend rate for 2000 was assumed to decrease gradually to an estimated annual increase of 5.0 percent in the year 2007 and thereafter. The health care cost trend rate for 1999 was assumed to decrease gradually to an estimated annual increase of 5.5 percent in the year 2003 and thereafter.

9. Employee Benefits (continued)

The assumed health care cost trend rate has a significant effect on the amounts reported. A one-percentage-point change in the assumed health care cost trend rate would have the following effects:

	December 31,	
	2000	1999
Effect of a one-percentage point increase		
Year-end benefit obligation	\$ 1,738	\$ 2,463
Total service costs and interest components	285	166
	December 31,	
	2000	1999
Effect of a one-percentage point decrease		
Year-end benefit obligation	\$ (1,462)	\$ (2,024)
Total service costs and interest components	(229)	(127)

NASD also maintains a voluntary savings plan for eligible employees of its subsidiaries. Employees are immediately eligible to make contributions to the plan and are also eligible for an employer contribution match at an amount equal to 100 percent of the first 4.0 percent of eligible employee contributions. Eligible plan participants may also receive an additional discretionary match from the Company. Savings plan expense for 2000 and 1999 was \$10.7 million and \$11.2 million, respectively. The expense included a discretionary match authorized by the Board of Governors of the NASD totaling \$3.5 million for 2000 and \$3.9 million for 1999.

In December 2000, the Nasdaq Board of Directors approved the implementation of an equity incentive plan and an employee stock purchase plan. The plans will be submitted

to Nasdaq stockholders for their approval. As of December 31, 2000, no grants had been made under the plans.

In May and July 2000, restricted common stock and options on common stock of Nasdaq Japan were awarded to certain Nasdaq officers and key employees who devote substantial time to the business of Nasdaq Japan. These awards contain restrictions and are subject to vesting provisions. The stock options were granted at an exercise price of \$500.00 per share, the estimated fair value of the stock at the time of the award. They are exercisable for a period of 7 years, and are subject to vesting provisions of 3 years. As of December 31, 2000 there were 205 stock options outstanding, none of them exercisable, with an approximate value of \$24,700.00 per share. The restricted stock award was for 475 shares at the estimated fair value of \$500.00 per share.

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (DOLLARS IN TABLES IN THOUSANDS)

9. Employee Benefits (continued)

As of December 31, 2000, the restricted stock had an approximate value of \$25,000.00 per share, and one-third of the shares were vested. In April 2001, Nasdaq Japan shares split four-for-one.

These awards are marked to market, and the fair value is being expensed over the vesting periods. Nasdaq recorded approximately \$3.8 million in compensation expense during 2000 related to these awards.

Future minimum lease payments under noncancelable operating leases with initial or remaining terms of one year or more consisted of the following at December 31, 2000:

Year ending December 31:		
2001	\$	31,449
2002		32,189
2003		26,690
2004		25,783
2005		24,593
Remaining years		203,508
Total minimum lease payments	\$	<u>344,212</u>

Future minimum lease payments under noncancelable capital leases with initial or remaining terms of one year or more consisted of the following at December 31, 2000:

Year ending December 31:		
2001	\$	10,200
2002		8,705
2003		3,460
2004		-
2005		-
Remaining years		-
Total minimum lease payments	\$	<u>22,365</u>

11. OptiMark Warrants

In connection with the OptiMark®, Inc. ("OptiMark") partnership, OptiMark agreed to issue to Nasdaq warrants to purchase up to an aggregate of 11.25 million shares of its common stock, \$0.01 par value per share. 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 securities traded through the OptiMark Trading System. The first milestone was the warrant commencement date, which occurred on October 11, 1999. On that date, Nasdaq received two fully exercisable warrants from OptiMark to purchase 4.5 million shares. The first 2.25 million shares may be purchased at an exercise price of \$5.00 per share. All remaining warrants provide that shares may be purchased at an exercise price of \$7.00 per share. The warrants are exercisable through the earlier of (i) the last day that the OptiMark System continues to be available on all Nasdaq workstations and (ii) the fifth anniversary of the warrant commencement date, or October 11, 2004. As of October 11, 1999, these warrants had a combined value of \$33.5 million which is considered to be the cost of these warrants. The deferred revenue associated with these warrants was to be amortized into income based on share volume traded through the OptiMark 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 System. As a result, Nasdaq management has concluded that its investment in warrants in OptiMark, as well as the realization of the deferred revenue related to these warrants, is impaired. Therefore, in September 2000, Nasdaq reduced its investment in warrants and related

deferred revenue to zero. Nasdaq continues to monitor OptiMark's implementation of its new business model and assess the value of the warrants at each balance sheet date.

12. Commitments and Contingencies

In November 1997, Nasdaq entered into a six-year agreement with MCI WorldCom to replace the existing data network that connects the Nasdaq market facilities to market participants. The contract contains a series of market participant usage-related guarantees. Nasdaq paid a deposit of \$8.0 million related to the agreement. Nasdaq has guaranteed to MCI WorldCom that the market participants will generate a minimum of \$300.0 million in usage under the contract from inception through November 2003. If \$350.0 million of the service is used, \$4.0 million of the deposit will be returned to Nasdaq. If \$400.0 million of usage is achieved, the full \$8.0 million will be returned. Cumulative billings under the contract were \$143.3 million as of December 31, 2000. As of December 31, 2000, the deposit has been fully reserved, based on projected usage under the contract. Management anticipates that the minimum guarantee under the contract will be achieved.

In October 2000, Nasdaq entered into a contract with OptiMark under which OptiMark was engaged to provide software development services in connection with the development of the SuperMontage system. Nasdaq will pay OptiMark for the SuperMontage development for a period not to exceed 12 months. Additionally, OptiMark will be entitled to receive incentive payments if it meets certain delivery milestones agreed to in the contract. If Nasdaq uses OptiMark's services for the full twelve months of expected development effort and OptiMark meets all of its deliverables, then Nasdaq will be required to pay up to \$14.9 million.

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12. Commitments and Contingencies (continued)

The transaction agreement entered into by the NASD related to the acquisition of Amex, Inc. included a Member Equity Program (the "Program") to support the value of Amex Members' seats. On October 30, 1998, the closing date, the NASD committed \$30.0 million to support seat prices with an additional \$10.0 million commitment effective on January 1, 1999. This fund can grow without a cap through buying, selling and leasing seats as well as a 5.0 percent return on the account.

Under the Program, an elected Seat Committee will monitor the effectiveness of the Program at 18 months, 36 months, and 60 months from the acquisition date. At the time of the reviews, the Seat Committee will determine, subject to a majority vote of the Amex members, the disbursement of portions of the initial commitment amount in one of the following ways: to owners of membership interests in Amex; as a reduction of Amex Exchange fees; and/or for investments in technology. Additionally, the Seat Committee may elect a roll-over option under which it would not disburse funds until the next review date. After five years, the undistributed amount will be eligible for distribution to the Amex members, reduction of Amex fees or investments in technology as determined by a membership vote. Every two years after that, the remainder will be eligible for distribution in the same manner until the commitment has been fully paid. The commitment will be funded from operations of the NASD.

As of December 31, 2000, no seats were purchased by the NASD under the Program. At the time of the 18-month review in June 2000, the Seat Committee recommended,

and the members approved a disbursement of \$15.0 million to the Amex membership. Accordingly, as of December 31, 2000, \$25.0 million remains outstanding under this commitment.

Also as a condition of the acquisition, a Member Supplement Fund was established under which annual distributions may be made by the NASD based upon 15.0 percent of the amount, if any, that the net income of Amex exceeds established thresholds for the years 1999 through 2008. Funds will be distributed to owners of membership interests in Amex or used to pay for investments in technology as determined by a Member Supplement Fund Committee. No payments were required to be made for 2000 and 1999 under the Member Supplement Fund formula.

Any contingency payments to members made under the Member Equity Program or the Member Supplement Fund are accounted for as contingent consideration through an adjustment of the original purchase price allocation.

The NASD and the Amex also entered into a Technology Transfer and Development Agreement (the "Technology Agreement") whereby \$110.0 million will be disbursed over the next five years for the purpose of operating and upgrading Amex's trading market and administrative systems. To the extent that Amex's revenues are not sufficient to fund this \$110.0 million program as scheduled, the NASD will spend or make available the difference through capital contributions, loans, or guarantees of loans. Management calculates that this commitment has been fully met as of December 31, 2000; however, this remains subject to the final review and approval of the Amex Committee.

12. Commitments and Contingencies (continued)

From the \$72.1 million in net proceeds the NASD received for the sale of Warrants and shares of Common Stock in Phase I, the NASD established a \$25.0 million earmark for the benefit of Amex to support Amex business operations and meet the NASD's obligations to Amex arising out of its acquisition of Amex. In October 2000, the NASD funded this \$25.0 million to Amex in the form of a capital contribution. Additionally, from the Phase I proceeds, the NASD established a \$25.0 million earmark for the benefit of NASDR to fund membership fee reductions. Approximately \$7.0 million in member fee credits were given to NASD members in 2000. Future cumulative fee reductions are expected to be \$107.0 million through 2006. It is expected that the NASD will establish additional earmarks of \$25.0 million each to Amex and NASDR from the \$113.4 million in net proceeds from Phase II (see Note 14). Additionally, the NASD will establish additional earmarks from the proceeds received upon exercise of the Warrants.

Securities Industry Automation Corporation ("SIAC"), an affiliated company, has a lease agreement for a data processing site. SIAC's performance under the terms of the lease, which has a remaining obligation of approximately \$70.8 million over the next six years, has been guaranteed by the New York Stock Exchange (the "NYSE") as majority owner of SIAC. Amex has agreed to indemnify the NYSE for a portion of losses, if any, sustained by the NYSE in the event of a default by SIAC. The Amex's share of potential losses (approximately \$14.0 million, or 20.0 percent, at December 31, 2000) is based upon its utilization of SIAC services for the preceding three years, and is adjusted annually.

On June 1, 1999, the NASD finalized a 10-year agreement (the "Agreement") with EDS Corporation to establish an alliance, NasTech, through which EDS provides technology services to the NASD and NASDR. The NASD has an obligation to pay to EDS a minimum of \$51.2 million each year under the term of the Agreement except for 2009 which will be prorated through the ending date of the Agreement on May 31, 2009. Additionally, in the event that the NASD terminates the Agreement for convenience, it is subject to a termination fee to EDS. The termination fee is based upon a formula which considers total EDS billings and profit through the date of termination and remaining minimum payments after the date of termination. If the Agreement was terminated effective December 31, 2000, the NASD would have been obligated to pay EDS a termination fee of \$76.0 million.

The Company may be subject to claims arising out of the conduct of its business. Currently, there are certain legal proceedings pending against the Company. Management believes, based upon the opinion of counsel, that it has adequately provided for any liabilities or settlements arising from these proceedings. Management is not aware of any unasserted claims or assessments that would have a material adverse effect on the financial position and the results of operations of the Company.

13. Business Segment Information

The NASD manages three primary business segments: Nasdaq, Amex and NASD. As described in the summary of significant accounting policies, Nasdaq and Amex represent separate identifiable organizations. NASD includes NASD, NASDR, and NASD DR.

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13. Business Segment Information (continued)

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.

Amex — Uses a specialist system to operate a floor-based exchange. The majority of this business is transacted with listed companies and firms in the broker/dealer industry within the U.S.

NASD — Through NASDR performs the regulatory functions of the Company, including on-site examinations of member firms, continuous automated surveillance of markets oper-

ated by Nasdaq, and disciplinary actions against broker/dealers and their professionals. Fees are assessed to cover particular services, both regulatory and non-regulatory, and member assessments are levied to cover examinations and related regulatory functions. Through NASD DR, provides arbitration and mediation services.

Segment Income or Loss

The NASD's accounting policies for segments are the same as those described in the summary of significant accounting policies. Management evaluates segment performance based on operating income or loss before income taxes. Prior year segment information has been restated to conform with the current composition of reportable segments. Transfers between segments are accounted for at cost.

	2000			
	Nasdaq	Amex	NASD	Consolidated
Revenues, principally from external customers	\$ 852,822	\$ 270,431	\$ 431,343	\$ 1,554,596
Total operating expenses	638,821	260,209	338,485	1,237,515
Net operating income	214,001	10,222	92,858	317,081
Provision for income taxes	90,477	4,600	—	95,077
Minority interests, net	(872)	—	6,338	5,466
Total assets	1,171,133	293,588	812,812	2,277,533
Working capital, net of restricted investments	432,767	19,498	115,797	568,062
Capital expenditures, excluding capitalized software costs	119,040	42,540	105,728	267,308

13. Business Segment Information (continued)

	1999			
	Nasdaq	Amex	NASD	Consolidated
Revenues, principally from external customers	\$ 646,449	\$ 230,628	\$ 367,468	\$ 1,244,545
Total operating expenses	501,879	212,865	309,574	1,024,318
Net operating income	144,570	17,763	57,894	220,227
Provision for income taxes	58,421	7,990	-	66,411
Total assets	583,415	164,751	562,476	1,310,642
Working capital, net of restricted investments	154,371	34,614	77,293	266,278
Capital expenditures, excluding capitalized software costs	94,193	21,837	80,443	196,473

14. Subsequent Events (unaudited)

Phase II Private Placement

Phase II of the Restructuring closed on January 18, 2001 yielding net proceeds to the NASD and Nasdaq of approximately \$113.4 million and \$63.7 million, respectively.

Phase II of the Restructuring consisted of three separate transactions: (1) the NASD sold 4,222,295 NASD-owned common shares of Nasdaq at \$13 per share generating net proceeds of \$53.5 million and recorded a gain of \$31.4 million; (2) the NASD sold 4,392,345 warrants to purchase an aggregate of 17,569,380 NASD-owned common shares of Nasdaq at \$14 per warrant generating net proceeds to the NASD of \$59.9 million; and (3) Nasdaq sold 5,028,797 newly issued common shares at \$13 per share generating net proceeds to Nasdaq of \$63.7 million.

SIAC

In January 2001, the Amex Board approved a plan to sell Amex's equity interest in SIAC to the NYSE. Under the terms of the preliminary agreement, Amex will sell its one-third interest in SIAC to the NYSE for \$30.0 million and will assume direct control of the Amex related development and operations services in place at SIAC. No loss is expected to be recognized on the sale. SIAC staff who work directly and solely on Amex matters will become Amex employees. Additionally, Amex plans to enter into agreements that will govern Amex's continued use of SIAC facilities and shared services, including the SIAC data center and communication networks, for the next 10 years.

Nasdaq Europe Planning Company Limited

In February and March 2001, Nasdaq repurchased the ownership interests of certain minority shareholders in Nasdaq Europe Planning Company Limited for a total of \$20.0 million.

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14. Subsequent Events (unaudited) (continued)

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. ("EASDAQ"), a Belgium-based, pan-European stock exchange for \$12.5 million. Nasdaq restructured the company into a globally linked, pan-European market and renamed it Nasdaq Europe S.A./N.V.

Nasdaq's acquisition has been accounted for using the purchase method of accounting and resulted in goodwill of approximately \$4.9 million.

In June 2001, Nasdaq Europe S.A./N.V., sold approximately an 11 percent stake to a group of 8 major U.S. and European securities firms. The sale yielded net proceeds of approximately \$9.6 million and reduced Nasdaq's ownership in Nasdaq Europe to 60.5 percent (52.7 percent after potential dilution of outstanding warrants).

Nasdaq Sale of Convertible Subordinated Debentures

On May 3, 2001, Nasdaq issued and sold \$240.0 million in aggregate principal amount of its 4.0 percent convertible subordinated debentures due 2006 (the "Subordinated Debentures") to Hellman & Friedman Capital Partners IV, L.P. and its affiliates (collectively, "Hellman & Friedman"). The annual 4.0 percent coupon will be payable in arrears in cash and the Subordinated Debentures will be convertible at any time into shares of Common Stock at \$20.00 per share, subject to adjustment.

On a fully diluted basis, Hellman & Friedman will have an approximate 9.8 percent equity ownership position in Nasdaq. Nasdaq has agreed to use its best efforts to seek stockholder approval of a charter amendment that would provide for voting debt in order to permit Hellman & Friedman to vote on an as-converted basis on all matters on which common stockholders have the right to vote, subject to the current five percent voting limitation in Nasdaq's Restated Certificate of Incorporation. Nasdaq has granted Hellman & Friedman certain registration rights with respect to the shares of Common Stock underlying the Subordinated Debentures. Additionally, 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 Debentures and/or shares of Common Stock issued upon conversion representing at least 50 percent of the shares of Common Stock issuable upon conversion of the Subordinated Debentures initially purchased. Effective May 3, 2001, F. Warren Hellman was elected to Nasdaq's Board of Directors pursuant to the foregoing provision.

Nasdaq Purchase of Nasdaq Shares Held by the NASD

On May 3, 2001, Nasdaq used the net proceeds from the sale of the Subordinated Debentures to purchase 18,461,538 shares of Common Stock from the NASD for \$13.00 per share or an aggregate purchase price of \$240.0 million. As of May 4, 2001, the NASD owns 69.8 percent of Nasdaq. On a fully-diluted basis, the NASD's ownership would be decreased to 27.6 percent.

14. Subsequent Events (unaudited) (continued)

LIFFE

On June 1, 2001, Nasdaq and the London International Financial Futures and Options Exchange ("LIFFE") formed Nasdaq LIFFE, LLC, a new U.S. joint venture company to list and trade single stock futures. The products of this joint venture are expected to be traded through a modified version of the LIFFE CONNECT™ electronic system. Nasdaq has committed up to \$15.0 million plus the rights to use certain trademarks in this venture. On August 21, 2001 the Commodity Futures Trading Commission approved Nasdaq LIFFE as a futures market and self-regulatory organization.

Stock-Based Awards to Officers and Employees

On February 14, 2001 Nasdaq granted 9.6 million stock options and 534,850 shares of restricted stock to certain

employees and officers pursuant to its Equity Incentive Plan. Under the plan, Nasdaq grants stock options with an exercise price equal to the fair market value of the stock at the date of grant. Nasdaq accounts for stock option grants in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and accordingly, recognizes no compensation expense related to such grants.

Restricted stock awards are awarded in the name of the employee or officer at fair value at the date of grant. The awards contain restrictions on sales and transfers, and are generally subject to a five-year vesting period. The 534,850 shares of restricted stock were awarded at a fair value of \$13.00 per share and are being expensed over the vesting period.

REPORT OF INDEPENDENT AUDITORS

Board of Governors National Association of Securities Dealers, Inc.

We have audited the accompanying consolidated balance sheets of the National Association of Securities Dealers, Inc. as of December 31, 2000 and 1999, and the related consolidated statements of income, changes in members' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with 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 consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the National Association of Securities Dealers, Inc. at December 31, 2000 and 1999, 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.

As discussed in Note 4 to the consolidated financial statements, in 2000 the Company changed its method of accounting for certain issuer services revenues. Also, as discussed in Note 3 to the consolidated financial statements, effective January 1, 1999, the Company adopted Statement of Position 98-1 "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use."

Ernst & Young LLP

Washington, D.C.
February 26, 2001, except for Note 4,
as to which the date is August 17, 2001

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